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Private Equity Buyouts of Public Utilities: Preparation for Regulators

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With the 1985 merger of Cleveland Electric Illuminating and Toledo Edison (both now part of FirstEnergy), the U.S. energy utility industry began a merger trend that had seen few such transactions since the 1930s. By the late 1990s, gas and electric utilities had participated in several dozen such transactions. Following the Western energy crisis of 1991-2001, the number of mergers per year declined, as companies considered what type of corporate and market structures best served their purposes. With the 2005 repeal of the Public Utility Holding Company Act of 1935 (PUHCA), whose "single integrated public-utility system" requirement limited the geographic and type-of-business scope of gas and electric utilities, utility mergers have begun to increase in number. New merger structures have emerged as well. Whereas the parties to prior mergers were publicly traded firms, a new participant in the most recent round of mergers has been the private equity firm, using an acquisition technique known as the "leveraged buyout."

This paper prepares regulators to address mergers, with a focus on private equity buyouts. It analyzes the rationales for mergers, the differences between a private and a public buyout of a utility company from both a financial and regulatory perspective, as well as the public policy implications of that difference. The paper then outlines regulatory action that will help to ensure that the target utility continues to attract capital and execute its public service obligations at the lowest reasonable cost to ratepayers.

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Introduction

Utility regulation is designed to duplicate the market discipline imposed by competition. Regulation thus supports the interests of both investors and ratepayers by setting rates that recover prudently incurred costs, including the cost of capital. The utility can then fund its ongoing, efficiently-managed operations and attract the capital to build the facilities necessary to fulfill its obligation to serve the public at the lowest reasonable cost.

In this regulatory process, the public interest is paramount. That is, there are private interests (e.g., ratepayers' desire to receive utility service at little or no cost, investors' desire to receive a high return with little or no risk) that do not serve the public interest of providing ubiquitous service at reasonable cost. Regulation reigns in private interests where necessary in favor of the broader public interest of providing the utility services required by society at the lowest reasonable cost. Only in that way are the societal benefits of utility service maximized.

It is in that light that we review private equity buyouts of public utilities. This paper does not provide a determination of whether the purchase of a public utility by a private equity firm or partnership is "good" or "bad" for society in the long run. Rather, through a review of the motives of the parties participating in mergers generally, and private equity buyouts in particular, and an examination of how those motives influence merger mechanics, we identify areas in which private interests diverge from public interests. Identifying those possible divergences exposes areas where regulators should intervene. We suggest appropriate tools for that intervention—tools with which a pending corporate combination can be more thoroughly evaluated, potential conflicts addressed, and the public interest better served.

To understand the nature of a private equity buyout and the rationale motivating the parties in such a transaction, it is necessary first to briefly review corporate mergers, generally, the recent history of utility mergers in the U.S., as well as an overview of the nature of private equity buyouts. Following that, we examine in greater detail the aspects of a private equity buyout of a public utility that may conflict with the public interest, and suggest measures regulators can use to help bring the private and public interests in line.

Part I of this study describes mergers and acquisitions, the reasons why corporations combine, and the ways in which those combinations are undertaken, and reviews the recent history of completed mergers in the electric and gas utility industries. Part II explains how private equity buyouts are different from mergers of publicly traded firms, and illustrates those differences with reference to the on-going purchase of TXU by a private equity firm. Part II also discusses the positive and negative impacts of the use of leverage—a primary component of a private equity buyout—as well as other aspects of an LBO. Part III introduces the reader to the different parties involved in a private equity buyout of a utility and their part in the process. Part IV discusses the regulatory concerns related to private equity buyouts, focusing on the potential for

conflict between the private interests and the public interest attendant to utility operation. Part V discusses other aspects of a private equity buyout that also present potential conflicts for the regulator. Finally, Part VI discusses methods by which regulators can more thoroughly evaluate a private equity buyout and suggests methods and requirements that can address public/private interest conflicts where they occur.

I. The Fundamentals of Mergers and Acquisitions

A merger is a combination of two or more corporations into one. While two companies' top managements and boards of directors can simply decide to combine operations as a "merger of equals," more often one company acquires another. In the vast majority of mergers, one firm (generally the larger of the two) decides to buy another company, negotiates a price with the management of that firm, obtains shareholder approval if necessary, and then acquires the smaller company. Therefore, most mergers or combinations of corporate entities are acquisitions of one firm by another. Occasionally, the acquired firm initiates the action, but it is much more common for a firm to seek acquisitions than to seek to be acquired.[1] The firm that is to be acquired is referred to as the "target" firm.

A. Merger motivations

The motivation for one company to acquire another is similar to that in any investment decision, i.e., to earn a positive return, net of the cost of the investment, commensurate with the risk assumed. A merger or acquisition is deemed to be desirable to the acquiring firm if the merged company will make a net positive contribution to shareholders' combined wealth. In other words, from the investors' perspective, if the combination of Company A and Company B has a higher market value than the two companies individually, the merger has value and should proceed. Merger value arises from (1) operating economies (economies of scale related to management, production, or distribution), (2) financial economies (lower financial transaction costs for larger companies, better analyst coverage), (3) differential efficiency (if management of surviving firm is more productive than was the management of the acquired firm), and (4) increased market power in a geographic or product market of importance to the acquiring firm.[2]

In addition to these economic considerations, there are human factors involved:

> …[t]here can be no question that some business decisions are based more on managers' personal motivations than on economic analyses. Many people, business leaders included, like power, and more power is attached to running a larger corporation than a smaller one. Obviously, no executive would ever admit that his or her ego was the primary reason behind a series of mergers, but knowledgeable observers are convinced that egos do play a prominent role in many mergers.

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[1] Brigham, E., Gapenski, L. *Intermediate Financial Management, 5th Ed.,* Dryden Press, Fort Worth, TX, 1996, p. 831.

[2] Op. Cit., pp. 825, 826.

> It has also been observed that executive salaries are highly correlated with company size—the bigger the company, the higher the salaries of its top officers.[3]

B. Merger types and merger forms

Three types of mergers are generally recognized. A **vertical** merger is a combination of two companies in the same chain of production. It bridges one or more gaps between raw materials or other inputs and the finished product. An example would be a merger between a gas distributor and a gas producing operation. A **horizontal** merger is a merger between two companies in the same line of business, such as a merger between two gas distributors. This type of merger is generally the most common. Because a horizontal merger combines two or more firms competing to provide the same product or service, it often raises questions of market power or restricting competition. Finally, a **conglomerate** merger occurs when unrelated enterprises combine, such as a gas distributor buying a department store chain.

A merger or acquisition changes the ownership of pre-existing assets and businesses. That change of ownership can be undertaken in different ways. First, it is literally possible to merge two companies into one, where one company assumes all the assets and all the liabilities of the other. This type of merger must have approval of the majority of the stockholders of each of the firms involved. Second, one firm can buy the other firms' common stock in exchange for cash, shares of the acquiring firm or other securities. In this situation, the acquiring firm deals directly with the shareholders of the firm to be acquired, making a direct offer to buy their shares for a specified amount. The approval of the management of the target firm is sought and desired (and generally won in completed mergers), but is not necessary. (The term "hostile takeover" refers to acquisitions that do not have approval of target company management.) If the acquiring firm secures a controlling interest in the target firm, the acquirer can remove uncooperative management in the target firm. Third, the acquiring firm can purchase the assets of the target firm. In this instance, ownership of the assets must be transferred to the acquiring firm through the approval of the target firms' stockholders; payment is made to the selling firm rather than to its stockholders.[4]

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[3] Op. Cit., p. 828.

[4] Brealey, Meyers, Allen, *Principles of Corporate Finance, 8th Ed.*, McGraw-Hill Irwin, Boston, MA, 2006, p. 887. The purpose of this paragraph is to provide an overview of transactional concepts. In certain transactions there can be state corporate or securities law or federal securities law that would govern the requirements and procedures attendant to any merger or combination of operations by two or more companies.

C. Merger Beneficiaries

Although the finance literature indicates that mergers improve the position of the stockholders of the acquired company (who are rewarded by higher stock prices during the merger), the acquiring company, on average, realizes few benefits.[5] There are two primary reasons why the acquired firm's shareholders receive the larger benefit. First, the firms being acquired are generally smaller and, in many instances, the buyers are so much larger that even substantial benefits gained from the addition of a small company would have small impact on the bottom line of the larger firm. Assume, for example, that target company A was one-tenth the size of acquirer B. If those companies split the dollar gains from the merger equally, those same dollar gains will have a percentage return impact for A's stockholders that is ten times the return impact for the stockholders of acquirer B. The second reason that the acquired firm's shareholders benefit more than those of the acquirer is that, once a bid is made for the target company, and that company is "in play," there may be other bidders, and competition for the assets of the target firm drives up the price.

D. The pace of utility mergers in the U.S.

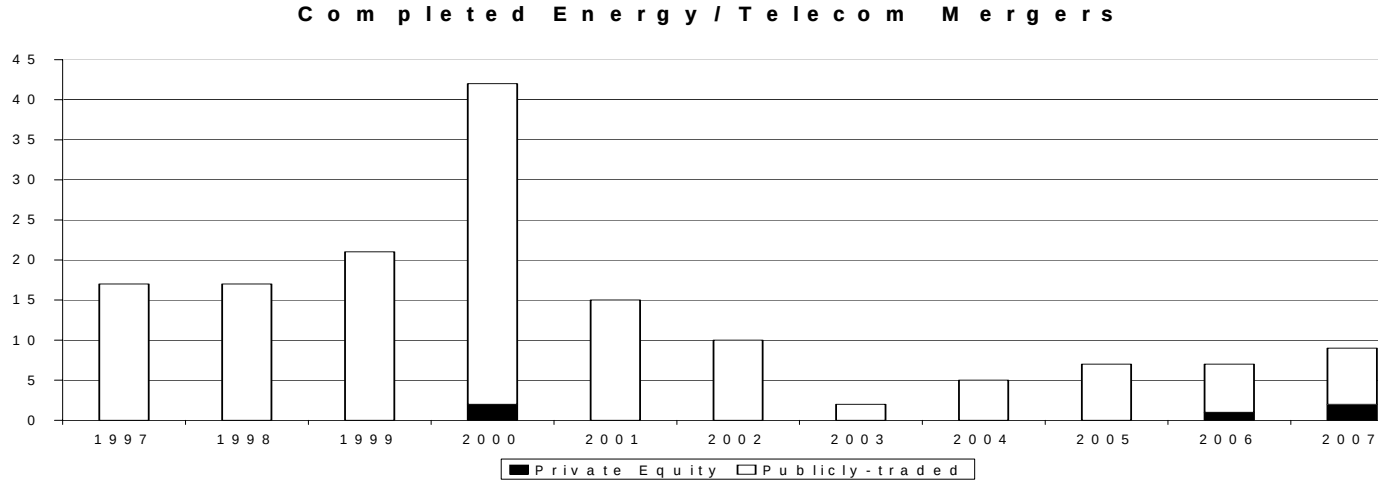
During the 1990s, legislators, regulators and industry actors debated the merits of competition at the wholesale and retail levels. Connected to the debate over industry structure was one over corporate structure—should utilities be vertically integrated or should they separate their competitive assets (generation, retail services) from their monopoly assets (transmission, distribution). A majority of states had active debates, and about 15 states enacted or promulgated some form of structural change. These structural changes led to an increasing number of mergers in the utility industries (gas, water, telecommunications). See Chart 1, below. The merger activity of all utilities increased during the late 1990s as increasing structural change was anticipated, and reached its zenith in 2000—the year preceding the Western energy crisis.

During the Western energy crisis, the potential shortcomings for both customers and investors in a competitive wholesale and retail market structure came into sharp focus. With energy trading firms manipulating prices and profits in a market characterized by a thin retail supply margins, coupled with a regulatory rate freeze scheme that prevented the retail utilities from passing on those commodity prices to customers, both investors and customers were ultimately disadvantaged by the financial stress placed on the regulated utilities. That disruption in the fabric of energy restructuring caused a marked slow-down in the move to introduce retail competition, with some states (e.g., Arizona, Arkansas, California) reversing or limiting prior pro-competition decisions. Since that time, much of the electric industry has adopted a "back to basics" strategy, i.e., shedding unregulated energy or other operations and focusing on "core" utility operations. With that change in attitude toward restructuring the utility

[5] *Id.* at p. 895; Shepherd, W., *The Economics of Insustrial Organization, 4th Ed.*, Prentice-Hall, New Jersey, 1997, p. 157; Brigham, E., Gapenski, L. *Intermediate Financial Management, 5th Ed.*, Dryden Press, Fort Worth, TX, 1996, p. 847.

industry, the number of mergers in the industry declined after 2000, reaching a nadir in 2003, and has, only in the last couple of years, begun to increase.

Chart 1



Data from AUS Utilities Reports, "AUS Merger and Acquisition Quarterly Report," July 25, 2007, pp. 59-74.

As Chart 1 indicates, private equity participation in completed electric utility mergers began in 2000, and has recently re-emerged. In the five years between 2000 and 2006, there were two instances in which private equity firms attempted to purchase utility operations but those applications were not approved by regulatory authorities.[6] Also because the current number of mergers per year is much lower than in 2000, current private equity-based mergers/acquisitions are a larger percentage of the total number.

[6] 2005-Portland General by Texas Pacific Group, 2004-Unisource Energy by KKR, AUS Merger and Acquisition Quarterly, July 25, 2007, pp. 78, 79.

II. Private Equity Buyouts

A. Ownership structure

The type of merger on which we focus here, private equity buyouts of public utilities, falls into the third type of merger category, the conglomerate merger, in which the acquiring firm purchases operations that are dissimilar to its own. In a private equity buyout, the acquiring "firm" is a group of investors. These investors are known as the equity partners. The group includes the general partner (who has responsibility for managing the investment, i.e., determining how the acquired firm will be operated), plus other partners (called limited partners) who contribute capital, but are otherwise passive owners. The "business" of private equity firms is investing, and is different from the business of, for example, manufacturing or transportation, or operating a public utility.

B. Financial structure

Today's private equity buyouts use a financing method introduced in the 1980s—the leveraged buyout (LBO). In an LBO, a large proportion of the monies necessary to complete the transaction (i.e., purchase the target company's outstanding stock) is provided by debt capital (leverage). As noted in Part I.B above, one of the methods by which one firm acquires another is to purchase the stock of the target company. With an LBO, the monies used for the purchase of the target firm's stock come, in part, from equity capital provided by the acquiring firm (the equity partners), but are primarily supplied by debt capital. The debt capital that is used to buy the target firm is issued upon completion of the acquisition and is secured by the income stream of the acquired firm. This acquisition debt, described in more detail subsequently, can be made to reside on either the target company balance sheet or that of the parent/acquiring company, but, in either event, becomes the responsibility of the merged company.[7]

[7] For expositional purposes, this paper focuses on a simplified case in which one equity firm buys one utility, with the one utility being the only source of income for the acquiring firm. In that case, it is clear that the only source of funds to service both the original utility debt and the transaction debt is the utility, regardless of whether the transaction debt resides on the books of the utility subsidiary or the parent following acquisition. However, private equity firms often have more than one type of investment and, thus, more than one source of funds for debt service. While, in that case, the primary source of the funds to service the transaction debt used to buy the utility continues to be the utility, the availability of additional cash flows from other investments to service transaction debt at the parent (equity firm) level would reduce the financial risk to the utility to some extent. Any financial risk reduction attendant to additional sources of funds at the parent level is mitigated by two factors: 1) the equity firm's other investments are also highly leveraged with thin operating margins and 2) the basic business risk of other competitive operations is likely to be higher than that of a utility, increasing overall risk.

The use of leveraged buyouts (LBOs) as a merger-financing tool began in the 1980s with the investment banking firm Drexel Burnham Lambert and Michael Milken. Prior to that time, institutional investors were generally unwilling to purchase high-yield bonds of risky companies. However, based on research that showed investors were more than adequately compensated for the risks assumed with high-yield bonds, Milken was able to convince investors of the merits of riskier, high-yield debt securities. With that new source of high-risk, high-yield debt funds available, the LBO merger "boom" of the 1980s was born. Enthusiasm for LBO financing and debt-fueled mergers abated with Milken's legal difficulties and Drexel's subsequent bankruptcy.[8] However, with the recent advent of private equity firms, the LBO has re-emerged as an accepted method of financing acquisitions.

For example, the recent bid by Kohlberg, Kravis, Roberts and Co. (KKR), and other equity partners for TXU Corporation, an electric utility, proposes to fund the acquisition primarily with debt. KKR's acquisition of TXU, (recently approved by TXU's shareholders) will be the largest LBO ever in the U.S—a total of $44 billion including assumed debt (i.e., the cost to purchase the equity of TXU ($32 Billion)[9] plus taking responsibility for the debt on TXU's books (about $12 Billion)). Here's how the transaction was described in the financial media:

> To fund its purchase of the soon-to-be-private company, the buyout fund puts up some cash – say, 25% of the total purchase price – and borrows the rest by issuing debt backed by the assets of the acquired company. So in buying TXU, the buyout fund might put up $11 billion in cash … and then sell $33 billion in TXU debt to big institutional investors to complete the purchase. In essence, the purchased company buys itself….
>
> Even before the deal, TXU was carrying a big load of short-term debt ($1.5 billion) and long-term ($10.6 billion) debt, and paying a sizable interest bill of $784 million in 2006. Adding an additional $33 billion or so in debt will run that interest bill significantly higher.[10]

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[8] Brigham, E., Gapenski, L. *Intermediate Financial Management, 5th Ed.*, Dryden Press, Fort Worth, TX, 1996, p. 526.

[9] KKR's cost to purchase TXU is set by KKR's offer to TXU's shareholders of $69.25/share times the number of shares outstanding at the time of the offer (about 460 Million).

[10] Juback, Jim, "The War For Your Electric Bill," MSN-Money.com, April 27, 2007,http://articles.moneycentral.msn.com/Investing/JubaksJournal/TheWarForYourElectricBill.aspx. Note: the data referenced are contained in TXU's 2006 S.E.C. Form 10-K, pp. A-77, A-81.

C. Profitability

Although LBOs have a high-risk, high-return reputation, studies of historical LBO-activity indicate positive, albeit relatively modest, results for equity investors. Studying the returns of LBO and Venture Capital firms from 1980 through 2001, Kaplan and Schoar[11] find that LBO firms have earned returns, net of fees, below that of the S&P 500. The "fees" are the costs paid by the partners in the equity firm to the general partner for managing the partnership. The general partner manages not only the acquisition process but also determines how the acquired firm will be operated (i.e., selects the management, determines which assets to sell). When those fees are included in the profitability figures, Kaplan and Schoar show that LBO firm returns have exceeded those of the S&P 500. That research also shows, over the same 1980-2001 time frame, that larger, established LBO funds perform better than first-time investment funds and that top funds have consistently better performance than average.

In recent years, private equity firms have outperformed the broader stock market, thereby attracting the interest of more investors. This growing investor interest indicates potential for additional private equity buyouts in the future:

> As private-equity funds have consistently beaten the markets, money has poured in by the billions. In 2007, according to industry professionals, U.S. private-equity firms could raise well more than last year's record $215 billion. Among the biggest firms, Kohlberg Kravis Roberts (KKR) recently closed a $16 billion fund, Goldman Sachs Capital Partners is rumored to be raising a $19 billion fund, and The Blackstone Group is said to be building a stockpile of more than $20 billion. Currently, by some estimates, private-equity firms are collectively sitting on a $400 billion war chest.
>
> Combine that with leverage, and private equity's buying power increases four- or five-fold. So while 2006 was a banner year for private equity—more than 27 percent of all acquisitions were made by financial buyers, according to investment-banking specialist Dealogic—2007 and 2008 promise to be even larger in terms of deal volume.[12]

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[11] Kaplan, S., Schoar, A., "Private Equity Performance: Returns, Persistence, and Capital Flows," *The Journal of Finance*, August 2005, p. 1794-95.

[12] McCafferty, Joseph, "The Buyout Binge, Private-equity Firms Are Gobbling Up Everything In Sight. How Long Can It Last?" *CFO Magazine*, CFO.com, April 1, 2007, http://www.cfo.com/article.cfm/8909971?f=search.

D. Mechanics

As noted in Part II, above, a primary financial characteristic of a private equity buy out is the use of a substantially more debt than equity in funding the purchase, as compared to traditional acquisitions. The private equity firm or partnership will offer the shareholders of the target firm a price for their stock that is above the current market price (otherwise the target company stockholders have no incentive to sell).[13] The total amount of monies necessary to buy the outstanding stock at this higher stock price is comprised of equity capital provided by the private equity investors (typically 25% to 35% of the total purchase price) plus additional debt to be issued upon completion of the deal. The additional debt needed to complete the transaction is secured by the assets and/or income stream of the acquired company.

Leverage (the use of debt financing) increases the profitability of a firm, while at the same time increasing its financial risk. Although actual merger/acquisition financial structures can be complex, the impact of leverage in an LBO is shown in the following simplified example. Assume a firm has $100 of assets that are financed with $50 equity and $50 debt, which has a debt cost rate of 5%. Also assume that our firm has an operating income (revenues less operating expenses) of $10.20. After paying interest expense of $2.50 ($50 debt x 5% cost = $2.50) and a 35% tax rate on the remainder, $5.00 remains for the owners, the equity-holders ($10.20 - $2.50 = $7.70 x (1-35%) = $5.00). That $5.00 of earnings, divided by $50 of equity capital is a 10% return on equity for our equity holders.[14] Our firm's balance sheet and income statement would appear as shown in Table 1 below.

Table 1

Original Firm

Balance Sheet				Income Statement	
Assets	$100	$50	Equity	Operating Earnings	$10.20
		$50	Debt @ 5%	Debt Expense	($2.50)
Total	$100	$100		Taxes	($2.70)
				Income	$5.00
		R.O.E. = $5/$50 = 10%			

[13] In more traditional mergers of publicly-traded firms, the acquiring firm also offers a price for the stock of the target firm that is higher than the current market price.

[14] We assume, for simplicity of exposition, that our firm's market price is equal to its book value. If the market price is higher than book value to begin with, the acquisition creates a larger "goodwill" asset; the results of financing with added leverage are the same.

Now assume that a private partnership wants to buy our firm and offers our shareholders $60, which they accept. The partnership raises the $60 necessary to purchase our firm by contributing $10 from the partnership and $50 from additional debt to be issued by the acquired company upon completion of the transaction. Because this new debt is in addition to the $50 of debt that already exists, it will be issued at a higher cost rate than the original debt; we'll assume 6% for purposes of this example.[15] The consolidated balance sheet and income statement of the post-acquisition, leveraged firm are shown in Table 2 below.

Table 2

Consolidated Leveraged Firm

Balance Sheet				Income Statement	
Assets	$100	$10	Equity	Operating Earnings	$10.20
Goodwill	$10	$50	New Debt @ 6%	New Debt Expense	($3.00)
		$50	Old Debt @ 5%	Old Debt Expense	($2.50)
Total	$110	$110		Taxes	($1.65)
				Income	$3.05
		R.O.E. = $3.05/$10 = 30.5%			

The assets of the new firm are comprised of the original $100 of operating assets and $10 of "goodwill," which is the difference between the original value of the firm and the purchase price (the equity was originally valued at $50 but the partnership paid $60, creating a goodwill asset of $10). The new balance sheet shows the partners' equity ($10), the new debt used to fund the purchase ($50) and the original debt ($50), which is assumed by the newly-acquired company in the acquisition. The capital structure of the original firm was 50% equity and 50% debt. Following the buyout, the consolidated capital structure consists of 9% equity ($10 equity/$110 total capital) and 91% debt ($100 debt/$110 total capital).

The post-acquisition income statement in Table 2 shows that the new leveraged firm has much higher interest expense: $2.50 from the original debt ($50 x 5% = $2.50) and $3.00 from the new debt ($50 x 6% = $3.00). When the new, higher interest expense is deducted from the operating earnings (which have remained the same—our company hasn't changed its business operations), and taxes are paid, the net income is $3.05. The new, post merger net income is substantially lower than the original net income ($5.00).

[15] Marginal debt costs are directly related to the financial risk of the firm. As the amount of debt used to finance assets increases as a percentage of total capital, the financial risk increases, and so, too, does the marginal cost of debt.

However, when the $3.05 net income is applied to the much smaller equity contribution (the partners' $10), the return on equity rises to 30.5%.

The term "leverage" reflects the ability of debt to increase or "lever" upward the rate of return to the equity holders. As shown in our example, the use of additional leverage has tripled the rate of return to the new equity owners, solely through the use of additional debt financing.

Before we leave this example, notice one more factor related to the use of leverage. Originally, our firm's tax responsibility was $2.70 (35% tax rate x ($10.20 less $2.50 debt expense) = $2.70). The tax responsibility of the new levered firm is much lower—$1.65—even though the operating income has not changed. That is because the increase in debt expense due to the leveraged buyout (the added $3.00 of new debt expense) is a deductible cost that lowers the taxable income. The result is a lower tax burden for the leveraged firm. This factor will be important subsequently when we discuss possible regulatory treatment of leveraged buyout transactions.

The primary negative aspect of the use of additional debt to finance operations is the increase in the risk of default by the acquired firm following the acquisition. As shown on the income statement of our new, levered firm, profits are significantly smaller due to the increased use of debt and the higher debt expense. As long as revenues, expenses and after-tax income are stable, the additional debt does not present a potential risk to the operation of the firm. In fact, if operating income were known with certainty the assets could be financed entirely with debt without financial risk. However, real-world firms do not operate in a perfectly stable environment; revenues, expenses and after-tax incomes will certainly vary from epectations, sometimes widely. Also, even though utility revenues and expenses are adjusted through a periodic rate making process, those adjustments occur with some lag; the utility must have the financial strength to weather periods in which monies available to service debt are below expectations.

As demonstrated in the income statement data of our post-acquisition levered firm, if fluctuations in revenues or expenses cause after-tax income to decrease more than $2.00 in any period, our levered company would not be able to meet its debt service requirements.[16] The consequences for the acquired company would be severe. (With the more conservatively capitalized original company, a $2 reduction in after-tax earnings would not jeopardize the ability to meet the lower debt service requirements.) The use of additional debt to finance operations also has the effect of making the equity holders' return more variable. That is, the same change in after-tax income would have a larger percentage change in the partners' return on equity than it would in our original owner's

[16] We assume in our example, again for simplicity, there is no additional cash other than after-tax earnings with which to pay debt expenses. In actuality, firm's can meet debt expenses with cash flows from non-cash expenses like depreciation when after-tax earnings are not sufficient.

return on equity. That added return volatility due to leverage also increases financial risk for the firm.

E. Advantages and disadvantages of a leveraged buyout

1. Advantages

An LBO has the following advantages for the post-acquisition entity: administrative cost savings, increased managerial incentives, increased managerial flexibility, increased shareholder participation and increased leverage.[17]

- Administrative cost savings: When a public company is acquired by a private equity firm, its public reporting requirements such as securities registration, annual and quarterly reports, S.E.C. reporting on insider trading, stock exchange reports, Sarbanes-Oxley reporting and the like can be avoided, along with the associated expense. All of those reporting requirements are designed to protect investors in a publicly traded firm by allowing them access to detailed financial and operational information about the firm. However, when a firm is owned by a small group of private investors, who have access to and knowledge of the operations through direct participation, the statutory public reporting requirements no longer apply.

- Increased managerial pay: When all of the stock of a public company is concentrated into the hands of a few owners, and the income stream accompanying that ownership is leveraged substantially, the private equity firm's profitability increases. That increased profitability, in theory, attracts higher-quality management resulting in a better-run firm.

- Increased managerial flexibility: In a private buyout, the new management does not have to focus on meeting short-term (e.g., quarterly) earnings targets: it has the freedom to engage in more dramatic restructuring, with long-term goals in mind. For example, a private equity firm would be able to sell assets that do not fit its long-term view of company operations, even if that sale worked to lower earnings in the short-term, whereas, public management might not undertake that necessary change due to the negative short-term earnings impact.

- Increased shareholder participation: This advantage of LBOs results from changing the ownership of a firm from a large body of relatively passive owners to a much smaller group of investors who take an active role in managing the firm. The smaller group of owners has increased incentive and ability to monitor management performance than does a large body of public stockholders. The private equity firm also often brings substantial financial expertise (the general

[17] Brigham, E., Gapenski, L. *Intermediate Financial Management, 5th Ed.,* Dryden Press, Fort Worth, TX, 1996, p. 497-498.

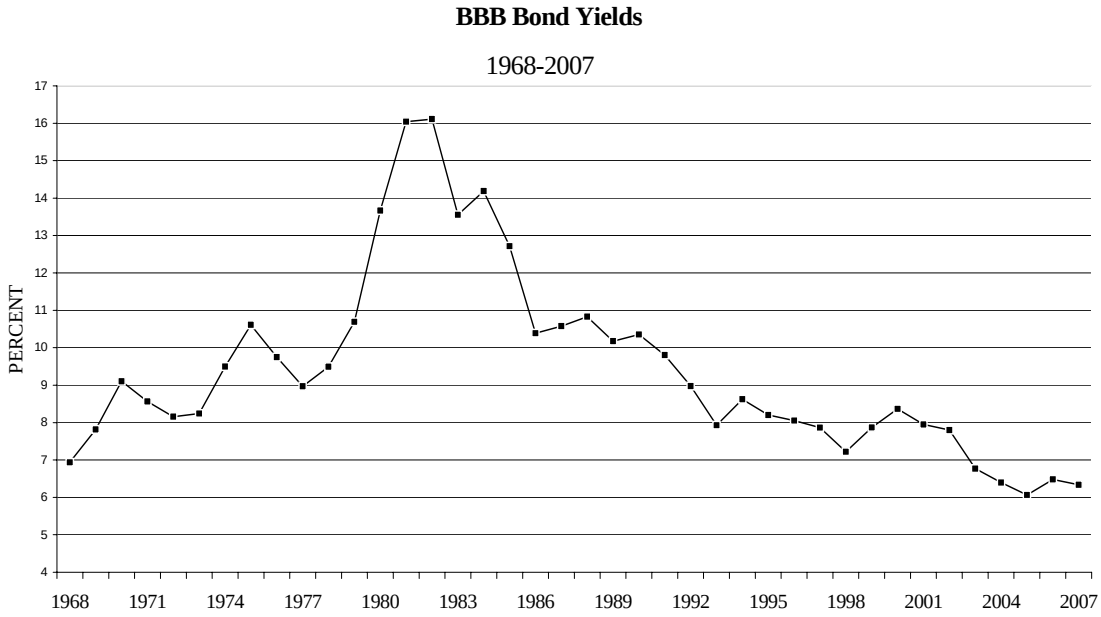
partners), who are willing to impose major operating changes that private management could be less reluctant to adopt.

- Increased leverage: The principal financial characteristic of a private equity buyout—the use of leverage—to finance the purchase, has two effects. First, the firm's taxes are reduced because the amount of interest payments (which are tax deductible) is increased relative to the debt costs prior to the transaction. Second, the high fixed costs associated with the additional debt burden (lenders must be paid, or default results) provides operating "discipline," requiring managers to cut costs or increase revenues in order to ensure the firm has sufficient cash flows to meet its new, higher debt obligations. Otherwise, the firm fails and has to seek bankruptcy protection.

The additional debt incurred in an LBO is not intended by those who structure such transactions to be permanent. The finance professionals who arrange LBO financing and the institutions that provide the transaction debt capital are quite aware that high debt ratios and debt expense increase risks for the firm. Therefore, the private equity buyout also includes detailed plans for buying down or re-financing the debt used to effectuate the deal. The high-yield debt issued to undertake the buyout is shorter-term in nature (five years or less), as compared to traditional utility debt of 20- to 30-year terms. The institutional investors that will be providing the high-yield debt funding the transaction scrutinize the details involved in the equity partners' plans for liquidating the high-yield debt, because a well-designed debt reduction plan can be key to the ultimate success of the transaction.

Also, the "discipline" that an LBO and the related higher debt costs imposes on a firm includes forcing management to decide which of the acquired firm's assets and personnel are essential to operations and which are not. The assets that are deemed to be non-essential are liquidated, with the proceeds used to buy down the high-yield transaction debt; and non-essential workers are terminated. If the sale of those non-essential operations and operating cost reductions do not provide enough capital to buy down debt to a level where financial risk is reduced, the high-yield debt will have to be re-financed (i.e., new debt will have to be issued to buy back the old debt). While current bond yields and capital costs are quite low by historical standards (as shown in the graph of BBB bond yields in Chart 2, below), capital markets are volatile and interest rates can change. Therefore, if the interest rate environment in the future is less benign that it is currently, re-financing large amounts of high-yield debt could prove to be difficult. That re-financing risk adds to the complexity of evaluating a private equity buyout that uses primarily debt financing.

Chart 2



Data from Federal Reserve Release H.15

2. Disadvantages

While the textbook rationale asserting the benefits of leveraged buyouts is well-founded, and the benefits to the private equity firm of a successful deal can be substantial, in practice, LBOs can be problematic for certain stakeholders. The holders of pre-existing debt in the target firm, for example, can be disadvantaged by the increased financial risk associated with an LBO. In reviewing those issues, Moody's, an investor service that publishes corporate bond ratings and opinions regarding bondholder interests, recently stated:

> LBO theory is based on the expectation that the benefits of leverage are twofold: it creates discipline within the corporate organization and it provides higher returns for the private equity firm. It is also frequently argued that the benefits of becoming a private company allow the management team to invest over a longer time horizon, unburdened by the demands of short-term focused public shareholders and without the expenses associated with public reporting requirements (i.e., Sarbanes Oxley and the like). Additionally, private equity firms assert that they have a unique ability to obtain good managers for their investments, a claim based mostly on their willingness to provide exceptional rewards for strong performance but also on their good relationships with business leaders….

> While Moody's would agree that leverage is likely to impose discipline and provide higher equity returns, the current environment does not suggest that private equity firms are investing over a longer term horizon than do public companies, despite not being driven by the pressure to publicly report quarterly earnings. We also question whether there is sufficient evidence to prove that the higher returns provided to private equity are driven by stronger management teams or because, in a benign and liquid credit environment, leverage by itself can provide substantial returns to shareholders. Moreover, many private equity firms pay themselves annual management fees as well as investment banking fees (for acquisitions, for example) increasing returns to the private equity firms…. We are less optimistic about the willingness of the private equity firms to inject capital in the future, if necessary, at a rate different from that of a strategic owner/operator would.[18]

[18] Moody's Investors' Service, Special Comment: "Rating Private Equity Transactions," July 2007, p. 2.

III. The Varying Motives of Stakeholders in a Private Equity Buyout

As explained in Part II, above, private equity investing is usually undertaken through a limited partnership structure in which the private equity firm acts as the controlling general partner. The limited partners consist primarily of institutional investors and individual investors who supply the bulk of the equity capital. The partnership requires the general partner to invest the funds within a certain time period (often five years). The general partner agrees to return capital to the limited partners within a certain time period (usually 10-12 years, total). Each fund or partnership agreement, therefore, is effectively a closed-end fund with a finite life. When the capital committed to one fund has been invested, the general partner attempts to obtain commitments for another fund, separate from the initial fund.[19]

The other stakeholders participating in a private equity buyout are the target company investors (shareholders and debtholders), the target company management (who could also be the management of the post-merger firm if the new owners do not install their own management team), and the lenders to the new company. This part discusses the economic position of each of those stakeholders relative to the transaction.

When the buyout offer is made, the **target company shareholders** are rewarded with an immediate increase in stock price with no increase in risk. If the deal is competed and the shares are sold to the equity buyout firm, the original shareholder has no interest in the acquired company or it's additional leverage-induced financial risk.

The **target company debtholders** could be disadvantaged if the target company's debt rating is lowered due to the debt service requirements related to the acquisition debt, and if the investors liquidate their holdings by selling their bonds. The market value of their debt will be reduced because other investors are not willing to pay as much for a promised income stream (the interest payments on the debt) if that income stream comes from a riskier source (one with a lower bond rating). Also, the coupon yield (the interest rate of the debt issue) associated with new firm is higher than the yield that would be available to a debt investor in the target firm. Therefore, even if the target company bondholders do not sell their debt, they are disadvantaged because the interest payments they receive are below the level appropriate for the new, more financially risky post-acquisition firm.

Because private equity buyouts focus on purchasing the outstanding stock of a firm (the acquiring firm deals directly with the shareholders of the target firm), the cooperation of **target company management** is not a necessity. However, because most states require regulatory approval for the acquisition of a utility operation, and because the target utility management has direct experience with regulation, it is reasonable to believe that any private equity firm would seek the favor of the utility target management toward the pending acquisition. Target company management also has detailed

[19] Kaplan, S., Schoar, A., "Private Equity Performance: Returns, Persistence, and Capital Flows," *The Journal of Finance,* August 2005, p. 1793

operational knowledge of the utility, knowledge that the buying firm (the equity partners) may not have. Also, if the target company managers are shareholders in the target firm, they will benefit like other shareholders, from higher stock price that results from the buyout.

The **lenders to the new, post-acquisition firm**, usually large institutional investors, unlike the target company debtholders, are able and willing to bear the risk associated with the lower-rated acquisition debt, in order to earn the higher returns commensurate with that debt. They also provide debt capital over a limited term, in anticipation of the borrower buying-down or re-financing the debt.

IV. Regulatory Concerns with a Leveraged Private Equity Buyout of a Public Utility

Part I above explained that regulatory concerns arise when there is a possible divergence between private interests and the public interest. A starting point for examining regulatory concerns, therefore, is to examine the private interests in a private equity buyout of a public utility to determine an opportunity for divergence between public and private interests. Recommendations for regulatory policy, then, can aim to align these interests with the public interest. In this Part, for each of five categories of participants we will describe the private interest and then assess whether and how that interest can diverge from the public interest. This approach necessitates that we begin with a discussion about the public interest.

A. The public interest in private equity buyouts

The overriding public interest in any change of corporate control of a public utility is the continued provision over the long term of reliable utility service at the lowest reasonable cost. That public interest includes, of course, the ability of the company to provide investors their cost of capital and, thereby, to be able to attract the capital necessary to maintain the present utility infrastructure build that needed in the future.

There are aspects of a change in ownership of a utility operation by merger or acquisition that could negatively affect that defined public interest. If the new company operates less efficiently, at current or higher cost, is forced to sell necessary assets to buy down acquisition debt, installs management unfamiliar with a regulatory environment, compensates that management based on performance criteria inconsistent with the utility's public service function, or cuts costs in areas necessary for the maintenance of and improvement its service quality, utility customers would be disadvantaged. Also, if the change of control is able to effect substantial cost savings, and those cost savings are not passed on to customers, regulatory legal obligations are not being realized because utility service is not being provided at the lowest reasonable cost. Shareholders and lenders also would be disadvantaged if, under the new owners, the utility operates poorly and regulators hold the utility accountable for that sub-par performance, since cost disallowances can reduce returns to investors. In addition, a change of control can be harmful to investors if operating or financial risk is substantially increased and investors are not compensated for that increase. As we discussed in Part III above, that can be the case with target company bondholders if the acquisition is financed with substantial additional debt.

Added concerns arise from human realities. Effective corporations are comprised of groups of people working under one particular corporate culture, with defined areas of responsibility, organizational hierarchies and work regimes. When one corporation acquires another, the acquiring corporation has to assimilate the work force of the acquired corporation into its own corporate culture, which may be very different than that

previously existing at the acquired firm. Overlooking this assimilation process will understate the costs and overstate the benefits of a merger or acquisition.[20]

Finally, changing corporate "culture" can also have positive impacts on the public interest. If, for example, utility management has over-staffed its operations because regulators are reluctant to call for force reductions, a new management perspective regarding the cost of operations and personnel efficiency could be beneficial. Such a perspective could provide lower-cost operations while continuing to provide safe and reliable utility service.

B. Private Interests

1. Owners of the acquiring company (the equity partners)

The interest of the acquirers varies with the type and purpose of the acquisition. There are at least three categories. In the first category, the acquirer is an existing utility seeking to merge with another utility, to achieve economies of scale or a strategic market position (e.g., a vertical or horizontal merger). The interest of the acquirers here would be to retain for shareholders some or all of the cost savings associated with the increase in economies of scale, or the increase in profitability associated with the improvement in market position. (We assume for purposes of discussion here that such a utility-utility merger has a long-term horizon and is not engineered for re-sale or a speculative return.) Merger combinations that achieve economies of scale and do not create market power advantages for the combined utilities are beneficial to the public interest as long as operating discipline and service quality are maintained, the acquisition and implementation costs do not exceed the savings, and the savings generated are passed on to ratepayers so that utility service continues to be provided at the lowest reasonable cost. To the extent the acquirers' interest diverges from this public interest prospective, regulatory intervention will be necessary.

In the second category, the private equity firm will not be seeking the multi-utility operations described in the preceding paragraph and thus will not have a long-term, "buy-and-hold" investment strategy. As noted in Part III above, the structure of a private equity firm is a partnership in which (1) the partners' capital is committed for a limited time and (2) the general partner (the private equity firm) is contractually required to return the partners' capital within a limited time period. The term structure of a normal private equity deal envisions a holding period of 5 to 10 years—shorter in nature than utility plant life and shorter than the planning period necessary for future utility plant additions. If the investment horizon of management is not aligned with the long-term nature of utility service, a potential for conflict between public and private interests exists.

[20] Rob Garver, "Merge Right, Numbers Don't Drive Deals. People Do." *CFO Magazine*, CFO.com, February 15, 2006.

Third, some private equity firms (e.g., Berkshire Hathaway) have established buy-and-hold investment strategies, which would tend to comport with the nature of utility investments, which are large, require substantial lead-times and have long lifetimes. A buy-and-hold investment strategy aligns the time frame of the investor with that of the public interest. Still, time frame alignment, alone, does not yield public interest alignment. The conglomerates that result from a buy-and-hold strategy could involve business and financial risks that distract or undermine utility management.

2. Shareholders of the target company

In the rate case context, utility shareholders and ratepayers appear to hold opposing private interests. Ratepayers want to pay less for their utility service and investors want a higher return while assuming no more risk. However, those stakeholders actually share the same public interest—a well-operated utility that provides safe, reliable, high-quality utility service as well as a fair return to investors, commensurate with the risk of the operation. If the private interests of either party prevail over the public interest, sub-optimality results. Overcompensating stockholders encourages overinvestment and higher-than-necessary prices; then ratepayers will have less disposable income available for more economically efficient uses. Under-charging ratepayers means investors earn sub-par returns, discouraging them from committing the capital necessary to maintain service quality.

A private equity firm buyout of a public utility company serves the private interests of the target firm's stockholders. To provide incentive for the current owners to sell their shares, the private equity firm will offer a price for the firm's stock that is higher than that available in the current market. For example, KKR's offer to TXU shareholders of nearly $70 per share represented approximately a 25% increase over the stock price prior to the offer (about $55/share).[21] This 25% premium, while appealing to the target shareholders' private interest, creates a potential conflict with the public interest, since the debt necessary to finance the premium could weaken the post-acquisition company.

3. Bondholders of the target company

Bonds are a lower-risk investment than the common equity of a firm for several reasons. First, under their lending contracts, bondholders' right to interest payments, and to redemption in the event of the firms dissolution, are contractually guaranteed. The bondholders are paid the interest due them even prior to the firm paying its income taxes. Unlike common equity which has no obligatory dividend amount or payment date, a bond provides the investor a specified amount and date of payments (e.g., an 8%, 20-year bond, with a $1000 face value will pay $40 twice a year on February 1 and August 1, every year the bond is outstanding, along with repayment of the $1000 at the end of the 20-year period). Compared to equity capital, therefore, the income stream from a bond is

[21] "Frequently Asked Questions Regarding the Merger Transaction," available on www.TXU.com, p. 2.

more certain. This lower risk of nonpayment reduces the return required by bond investors (and thus the cost of debt capital to the company), compared to common equity. The lower the risk of a bond, the higher its bond rating and the low the required interest rate.

The target utility's pre-acquisition bondholders are the stakeholders most likely to lose ground in a private equity buyout. If the private-equity firm leaves utility operations intact, so that the acquisition does not change the utility's ability to generate cash flow, the utility's ability to service the pre-acquisition debt would not be impaired. However, the additional interest costs imposed by the additional transaction debt the utility's risk of financial failure.

Even if the debt used to finance the buyout is made to reside outside the utility, such as at the "holding company" or other corporate level, the utility remains the source of the cash flows needed to service that additional debt. Consider our prior example explaining the impact of leverage, where the target utility has $100 of assets that are financed with $50 equity and $50 debt. Assume that the post-acquisition structure has a holding company format, where the private equity firm is the parent company and the utility is the only subsidiary. Assume further that, the new post-acquisition debt is issued through the private equity parent; the debt therefore resides on the parent's books. The utility's balance sheet after the acquisition would be unchanged by the acquisition:

Table 3

Utility Subsidiary

Balance Sheet

Assets	$100	$50	Equity
		$50	Debt @ 5%
Total	$100	$100	

Given the assumption that the $50 of new debt and the $10 of goodwill reside at the private equity firm (new parent) level, the capital structure of the parent company would appear as shown below:

Table 4

New Parent

Balance Sheet

Assets	$50	$10	Equity
Goodwill	$10	$50	New Debt @ 6%
Total	$60	$60	

Presented separately, these balance sheets appear to show that the financial risk of the utility subsidiary has not changed, and all of that additional risk falls on the parent company (the private equity firm). However, the utility common equity is the parent's only asset. The parent's ownership of that asset is the only means by which the private equity firm is able to finance the new debt issued to fund the buyout or make a profit. Moreover, creating a parent/subsidiary relationship and separate balance sheets for each entity does not change the consolidated balance sheet of the combined companies, shown below:

Table 5

Consolidated Leveraged Firm

Balance Sheet

Assets	$100	$10	Equity
Goodwill	$10	$50	New Debt @ 6%
		$50	Debt @ 5%
Total	$110	$110	

Separately reporting the balance sheets of the utility and its parent does not change the financial reality: the after-tax earnings stream of the utility operation is pressured by both the original $50 debt and the $50 acquisition debt. Therefore, even if the utility company bondholders have mortgage debt (debt secured by specific utility assets) or debentures that have priority status (i.e., to be paid before the acquisition debtholders are paid), their financial risk is increased by the added debt used to finance the buyout.

The interests of the target company bondholders can be affected by the additional leverage in additional ways. If the added debt is of sufficient size to cause a bond rating downgrade for the merged utility company, the target company bondholders could realize a loss of market value if they elect to sell their bonds prior to maturity. Prospective bond buyers would see their investment as lower in value and therefore pay less for the right to receive the remaining earnings stream. Also, the target company bondholders would be holding debt which has a coupon rate determined by the prior (higher, lower-risk) bond rating and does not compensate the target company debtholder for the additional risks occasioned by the buyout. The impact of buyout related leverage can be substantial, changing investment-grade debt to speculative debt.[22]

[22] "investment grade" is debt that is rated triple-B ("BBB-", Standard & Poor's; "Baa3" Moody's) or above. "BBB-", "BBB", "BBB+", "A-", "A", "A+", "AA-", "AA", "AA+", are all investment grade bond ratings (there are no U.S. utilities with bond ratings higher than AA). "Speculative grade" or "junk" debt is rated double-B or below.

On May 28, 2006 a group of investors led by Richard Kinder, Chairman of the Board and Chief Executive Officer of Kinder Morgan, Inc. (a gas pipeline and energy delivery holding company) made an offer to buy all of the outstanding shares of that company for a price approximately 18% above the then-current market price. The deal was to be financed with $4.5 billion of equity and $14.5 billion of debt.[23] The buyout deal was approved by the target company's stockholders. Kinder Morgan, Inc.'s bond rating dropped:

> On January 5, 2007, Standard & Poor's Ratings Services lowered its long-term corporate credit rating on Kinder Morgan Inc. (KMI) to 'BB-' from 'BBB'. At the same time, Standard & Poor's withdrew its 'A-2' short-term corporate credit and commercial paper ratings on the company….
>
> The ratings on the companies were originally placed on CreditWatch on May 30, 2006, following the announcement of an offer by a group of Kinder Morgan management and private investors to purchase the outstanding shares of KMI….
>
> The significant increase in debt that KMI will issue at the closing to fund the buyout will drop the credit profile well into the speculative grade area. The MLP is also affected by the transaction due its close ties with KMI, but management will be taking steps to insulate the partnership and preserve its investment-grade rating and the 'A-2' commercial paper rating.
>
> At the outset, KMI's debt will spike to levels that would not sustain the new ["BB-"] ratings, which are premised on the intent and ability of management over the next few years to accomplish sufficient asset sales and other means of raising cash to pay down the considerable debt burden.[24]

It is counter to the public interest to undercapitalize utility operations (i.e., finance with too little equity and too much debt). Undercapitalization creates potential for debt default and disruption of safe and efficient utility service, and raises the cost of acquiring debt capital. The private interests of the target company bondholders have some alignment with the public interest. However, the original bondholders' are also likely to encourage reducing financial stress through increasing utility revenues (raising rates), so as to increase interest coverages and lower the probability of default. Raising rates solely because of the selected financial structure of the merger would conflict with the requirement of providing utility service at the lowest reasonable cost, absent some public

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[23] Kinder Morgan, Inc. (KMI), "Kinder Morgan, Inc. Announces Receipt of 'Going Private' Proposal at $100 Per Share," press release dated May 29, 2006, available on KMI's website. http://www.kindermorgan.com/investor/kmi_press_releases.cfm

[24] Standard & Poor's RatingsDirect, "Kinder Morgan Downgraded Due to Debt-Financed Buyout," January 5, 2007, p. 1.

interest justification for the acquisition. Raising rates to increase interest coverage because of the additional transaction debt would also violate a fundamental rationale for LBOs—fiscal "discipline." The narrow interest coverages created by an LBO (because interest payment obligations have increased while operating revenue has stayed the same) are designed to facilitate management's re-evaluation of its assets and personnel, forcing management to eliminate those that perform poorly and enhance those that perform more efficiently. Raising utility rates and revenues weakens the incentive to take these "disciplining actions."

4. Management of the target company

It is common corporate practice to provide management with incentives to purchase the stock of the company they manage. Stock ownership aligns management interests with those of the company's stockholders. Where utility management does own stock, its interests, like the interests of target company stockholders generally, can conflict with the public interest in a private equity buyout. That is, the private interests of stockholders, which are furthered by large stock price premium offers, could out-weigh concerns regarding the long-term viability of the utility operations. Moreover, stockholders and management who sell their stock to a private equity firm have, literally, no interests in the surviving entity, and are no longer stakeholders in the fate of the privately-held company.

If the acquirer plans to retain target company management, there could be added incentives (increased pay, benefits) that could also cause conflicts with the public interest. If target company management becomes a partner in the buying group or initiates the buyout, the private interests of management may outweigh what is best for the long-term interests of the utility company. For example, according to the cited Standard Poor's report related to the Kinder Morgan buyout (a buyout led by target company management), to pay down the acquisition debt, the partners plan to sell the company's least risky assets—its U.S. gas distribution operations. That result does not imply that the divested utility operations will be worse off because of the sale, nevertheless it does demonstrate a difference between the private interests of management and the long-term interests of an operating utility.

5. Lenders to the acquisition

Lenders to private equity buyout transactions have shorter-term horizons than normal utility debtholders. The duration of LBO transaction debt tends to be shorter than utility debt, which is issued for terms up to 20 or 30 years. As such, while LBO-lenders do have a stake in the financial health of the company, it is focused on the three-to-five years during which they have committed funds to the acquisition. Their paramount interest is to ensure that the new firm's cash during that period meets its debt obligations. If opportunities to increase revenues or reduce expenses are not sufficient to provide the necessary cash flow, the acquisition lenders may advocate cost cuts or asset sales in the short term that could harm the company in the longer term.

The acquisition debt lenders' short-term focus also causes a mismatch between the length of the loan and the life of the underlying utility assets. This mismatch requires that the debt be refinanced after the term of the first loan ends. But at the time of the acquisition (and the regulatory review thereof), it is unclear what the refinancing rate will be. As of this writing (late 2007), private equity buyouts are occurring in a very liquid capital market with benign interest rates and low inflation. If that economic environment changes to one of tight money, so that the refinancing rates are much higher than current interest rates, that fact, alone could make the buyout uneconomic, from the company's long-term perspective.

V. Other Regulatory Issues Related to Private Equity Buyouts

A. Regulatory access to financial data

When public companies merge or issue equity or debt securities to the investing public, relevant information becomes public information. Federal statutes require that the financial structure of the firms before and after the merger, and the business organization, subsidiaries, and operational details of each of the companies be published in Securities and Exchange Commission (S.E.C.) documents, reports to shareholders, and proxy statements, all according to strict time schedules and specified standards of accuracy. The S.E.C. reporting requirements exist to inform investors the value and risks of the companies in which they invest. These reporting requirements apply both to acquisition transactions as well as to post-acquisition companies, when the stock of these companies is publicly traded.

The S.E.C. reporting requirements apply to all interstate offerings of new securities (equity or debt) to the public in amounts of $1.5 million or more. New securities must be registered with the S.E.C. prior to their issuance. The companies must publish a prospectus that describes the securities being issued and the firm that issues them. The S.E.C. has authority to impose severe penalties on the issuing firm or its officers, directors, accountants, appraisers, underwriters and any others who participated in the preparation of the registration statement or prospectus, if material information regarding the company or the securities is omitted or misstated.

In addition to publishing information on securities issuances, publicly traded companies must file at the S.E.C. a series of annual and quarterly reports. Those reports contain information about a company's revenues and expenses, accounting practices, its business platforms, corporate inter-relationships, operational details, potential risks, (including pending legal actions), as well as full financial statements (income statement, balance sheet and cash flow statement) and notes to the financial statements. The S.E.C. also requires corporate insiders to file monthly reports regarding changes in their stock holdings in the company. Finally, the S.E.C. regulates a company's proxy statement and the manner in which the company uses it to solicit votes.[25]

While the S.E.C. requirements seek to provide useful, in-depth information to the investing public, they do not regulate the wisdom of business practices. Suppose the boards of directors of a parent and subsidiary have the same members. The interf-affiliate relationship would not be arms-length; so the subsidiary's best interests would be subject to subordination by the parent. The S.E.C.'s concern is only that this information be properly reported accurately to investors. It is then up to investors to make their own decisions regarding those corporate actions.

[25] Brigham, E., Gapenski, L. *Intermediate Financial Management, 5th Ed.*, Dryden Press, Fort Worth, TX, 1996, p. 500-501.

This wealth of information made public through S.E.C. requirements reporting is only for publicly-traded companies. A privately-held company does not have those public reporting requirements. Without sufficient information regarding the financial structure of a buyout deal, it is difficult for a regulator to gauge the risk to the utility arising from the buyout.

Also, a private equity firm may have many different types of investments other than utility investments. See the discussion of "conglomerate' mergers in Part II, above. The acquiring private equity firm may have investments in, for example, insurance, overseas manufacturing or defense industries. The risks attendant to these other investments, which are likely to be higher than the operating risk of a utility (utility investment risk is below average), can affect the risk of a utility acquired by the same firm by raising the overall risk of the private equity firm (i.e., raising the probability of a debt default event). However, the details of a private equity firm's investment portfolio are not made public. The parent company's/private equity firm's interest in keeping this information private is not consistent with the public interest in effective regulation, which requires full information of all factors affecting the utility's financial health.

Furthermore, the inability to access key financial and operating data of private equity firms also presents difficulty for bond rating agencies:

> Some of Moody's credit concerns regarding sponsored [private equity] transactions are unlikely to be resolved because they arise from the lack of transparency typical of private equity firms. For example, in Moody's view, a sponsor's equity contribution in a leveraged transaction (LBO or acquisition) may not necessarily become a permanent part of the company's capital structure. We note that the amount of capital contributed tends to fluctuate at least in part because of several exogenous factors that analysts have little ability to measure:
>
> - the financial needs of the overall fund of which this investment is one part, and
> - the relative liquidity of the capital markets and opportunistic financing offered the firm.
>
> Moreover, we believe underperformance by a particular issuer in a private equity firm's portfolio can impact other issuers in the fund. If deterioration at one investment constrains a return of capital, it puts additional pressure on other firms in the portfolio to compensate.[26]

Moody's expresses concern regarding the "amount of capital contributed" in a private equity buyout, i.e., the amount of equity capital contributed to the buyout by the private equity firm. The higher the equity contribution, the less debt is needed to

[26] Moody's Investors' Service, Special Comment: "Rating Private Equity Transactions," July 2007, p. 3.

complete the transaction. Less debt in an LBO transaction means less financial risk for the merged company. The lack of transparency in private equity transactions prevents the bond rating agency from judging whether the firm has contributed the amount of equity originally intended or whether the equity contribution has changed due to capital requirements of other investments held by the private equity firm or due to the availability of debt (liquid capital markets). This lack of information can cause bond rating agencies to impute higher risk to the private equity transaction, which translates into higher capital costs.

B. Arm's length negotiations in the acquisition transaction

Many factors enter into the buyer's and seller's evaluation of a proposed private equity buyout. Those factors include the size of the acquisition premium, the amount and type of debt to use in funding the acquisition, post-acquisition cash flow scenarios, de-leveraging schedules, and executive governance decisions. As we have noted, although it is not strictly necessary that the buyout firm have the co-operation of target company management (the private equity firm could launch what is termed a "hostile" take-over bid, i.e., one not solicited or welcomed by target company management, appealing directly to the target firm stockholders), that management will typically play an important role in the merger transaction.

Target management's detailed knowledge of the target company's enables it to facilitate the acquisition, by providing accurate and detailed cash flow projections and by identifying assets appropriate for liquidation. Given that influential position, target company management can have the clout to negotiate terms for the acquisition—not as a disinterested party, but as a possible beneficiary of the transaction. Such circumstances conflict with the arms-length relationship that normally causes acquisition negotiations to produce results that are in the public interest, in at least two ways. First, the acquirers could promise target company management—implicitly or explicitly—certain benefits (e.g., salary, position, retirement package) in return for supporting the acquisition. Second, if the target company managers own a large number of shares of the target company, they would receive high profits on completion of the acquisition.

C. Buyer inexperience with regulated utilities

Some equity partnerships are first-time buyers of regulated utilities (e.g., KKR). Others have previous experience buying and running utility operations (e.g., Macquarie Group, Berkshire Hathaway[27]). Buyers with a track record of utility acquisitions that benefited the public interest would make better candidates. Operating a utility in close compliance with regulatory service mandates is quite different from operating a competitive enterprise (the type of firm most often acquired by private equity investors). In the former, the manager must meet public service requirements that do not exist in competitive industries. It is reasonable to whether a firm unfamiliar with the utility

[27] Berkshire Hathaway sells shares to the public, but is run by the managing partners, who hold the vast majority of the equity interest in the firm.

regulatory environment would have more difficulty operating under those oversight conditions than firms with prior experience in that realm.

D. Legal authority of regulators to review private equity buyouts

The authority regulators have to review, analyze and pass judgment on the acquisition of utilities under their purview varies from state to state. Some utility regulatory commissions have authority to oversee corporate change-of-control transactions, including private equity buyouts of utilities. Some utility regulatory commissions have specific legislative direction regarding their ability to oversee mergers that affect the utilities in their jurisdiction. Other regulatory bodies lack explicit merger authority, but might interpret their rate-setting authority to include review of these transactions.

Regulators need, at minimum, authority to limit the utility's ability to transmit cash to the parent or acquirer, where such cash flows conflict with the utility's public service obligations. Some utility commissions have explicit statutory power to limit utility dividend payouts or cash or security transfers to or from the parent in times of financial distress, and some do not. Nevertheless, as we see in the next part of this paper, the ability of the regulator to prevent the parent/acquiring firm unlimited access to the cash flow stream of the regulated utility can lower the risk and shore up the financial health of the utility.

VI. Options for Regulatory Action

A. Concerns regarding the use of debt in utility acquisitions

As we have seen, a key factor in a private equity buyout of a utility is the use of additional debt capital, secured by the utility's future cash flow, to finance the acquisition. The debt used to finance the purchase of the utility is in addition to the debt already on the utility's books. Bond rating agencies have voiced concerns regarding debt-funded acquisitions by private equity firms:

> The current environment of significant private equity deal volume, along with the very large size of some transactions, highlights concerns for Moody's analysts regarding the review of private equity sponsored transactions. While much transformation activity continues, creditors are not participating in the potential "upside" available to private equity firms or original shareholders. Future performance of current transactions will likely hinge on the economy remaining relatively stable and the credit markets remaining forgiving as many of these transactions will need to be re-financed in the coming years.
>
> Under these conditions Moody's:
>
> - is skeptical that stated plans to de-leverage or exit via the IPO [initial pubic offering] market will actually be carried out given current market conditions which provide ample opportunities for dividend distributions;
>
> - will continue to factor in the characteristics of an industry when evaluating the risk of high leverage, as well as opportunities for cost reductions and operational improvements, but notes that many recent leveraged buyouts ("LBOs") are in industries with high capital requirements, competition, or cyclicality, increasing risk;
>
> - has seen the equity component of private equity owned issuers diminish, making valuation more of a challenge, particularly as private equity firms increase dividend activity, sometimes

completely eliminating the amount of contributed capital in their investments[28];

- is concerned that debt holders have less rights given the prevalence of no or minimal financial maintenance covenants and modest amortization requirements among current transactions.[29]

Moody's lists five aspects of a private equity transaction that should also be of concern to regulators.

1. Asymmetry of risk and reward

Bond rating agencies are concerned that current bondholders will not "participate in the upside" potential of private equity buyouts enjoyed by the equity partners and by the target company shareholders. That is because the additional debt burden can raise financial risks to the point where the bond rating falls below investment-grade level. While utilities that fall below the debt rating of investment grade are able to attract capital, that capital has a much higher cost rate.

For example, while the annual cost rate differential between "A"-rated and "BBB"-rated utility debt may be 25 basis points (0.25%). The cost rate differential between "BBB"-rated and "BB"-rated utility debt can be 150 basis points (1.5%), or higher, depending on capital market liquidity.[30] Therefore the cost to a utility of a $100 Million debt issuance could rise $1.5 Million every year if its bond rating fell from "BBB" to "BB," if the cost rate of that issue increased 1.5%. There are other costs attendant to below-investment-grade debt as well. Purchased power suppliers may require up-front margin or collateral payments from utilities that have low bond ratings. This places additional cash requirements on the utility, cash requirements that would not exist absent the below-investment-grade bond rating. We do not suggest here that regulators must, in all instances, attempt to prohibit a utility from losing investment-grade

[28] In some recent transactions, the new private owners have declared special dividends that substantially reduce their own equity contribution to the merger after the merger is complete. (Moody's Special Comment, p. 3)

[29] Moody's Investors' Service, Special Comment: "Rating Private Equity Transactions," July 2007, p. 1.

[30] In a "liquid" capital market, such as that which we now enjoy, capital costs are relatively low and the differentials between investment grade and non-investment grade (junk) debt are narrower than they would be in markets where money flow is restricted (higher interest rates).

bond rating status.[31] However, if regulators have the choice of approving a private equity buyout, they must consider the risks of a lower bond rating.

2. Sensitivity to post-acquisition interest rate changes

Moody's is concerned that the future performance of the post-acquisition entity hinges on the continued stability of the capital markets and the continuation of relatively low interest rates. Those factors matter because the new high-cost debt issued to finance the largest part of the purchase price is relatively short-term in nature and must be re-financed within a few (usually five) years. As long as credit is easily available and interest rates remain low, refinancing the transaction debt will not increase costs; the cash flows available from the acquired utility then will still be sufficient to pay the interest on that debt. But if capital costs rise, debt becomes more expensive, weakening the acquired utility ability to refinance the transaction debt. Inability to refinance creates risk of default.

Regulators thus must consider future scenarios less benign than the capital market environment existing at transaction time. They must ask: "Can the post-acquisition utility survive, and thrive, if long-term T-Bond yields go from 5% to 8%, or 10%?" Any diligent investment banker will run such survivability tests. So must the regulator.

Moody's also expresses concern when private equity buyout plans include a post-acquisition public offering of stock as a means to buy-down the transaction debt.[32] The bond rating agencies' concern is that as long as interest rates remain relatively low, the equity firm will elect not to reduce the debt levels as planned. With continued lower interest rates, it would be less costly and much simpler for the equity partners to re-finance the transaction debt (thereby retaining the financial risk), rather than to issue new equity to buy down the transaction debt (which would lower financial risk). In order to mitigate the financial risk that exists following the acquisition, regulators should consider conditioning approval on meeting the debt reduction guidelines set out in the original acquisition plan.

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[31] For example, poor management decisions could cause a loss of investment grade bond rating and, if regulation is to be balanced, ratepayers should not be required to "guarantee" financial health or rectify inefficient corporate decisions.

[32] It may seem counter-intuitive that a firm would buy all the stock of a company to make it a private holding and then re-sell shares to the public. But this sequence fits an LBO's theoretical role in improving the efficiency of operations. (See discussion in Part II.E.1) The reasoning is that the equity partners, desiring to increase their investment's value, will re-focus the operations of the target company, by shedding inefficient operations. In the interim, they use leverage to boost the return on equity, then sell their equity interests in an improved company back to the public.

3. Special risks associated with capital-intensive industries

Capital intensive industries have a relatively large plant investment per dollar of revenue generated. Survival requires ongoing access to capital. The transaction debt added in a leveraged buy out reduces a utility's ability to issue additional debt, because lenders' risk rises as the amount of debt used by the borrower increases, and, at some point, the firm will not be able to generate the monies necessary to meet the debt costs. Also, this credit squeeze worsens if bond ratings are reduced below investment-grade, because some lenders (e.g., insurance companies, retirement funds) are prohibited by internal investment guidelines from investing in non-investment grade companies.

Utilities normally carry less equity and more debt than do unregulated industrial firms. AUS Utility Reports indicates that the average common equity ratio in the electric and combination electric and gas utility industry is about 45% of total capital (July 2007), while the Value Line Investment Survey reports that the common equity ratio of its Industrial Composite (630 industrial, retail and transportation companies) from 2001 through 2005 averaged about 60% of total capital.[33] The financial risk of utilities is therefore generally higher than average for other capital-intensive industrial firms. Consider also that the utility industry is on the verge of an unprecedented capital spending campaign to upgrade transmission infrastructure and to build the generation necessary to meet growing demand.[34] All of these factors call for additional scrutiny before approving the addition of the additional debt in a leveraged buyout of a utility by a private equity firm.

4. Special dividends reduce equity investment

The equity partners contribute a certain amount of equity to finance the purchase of the target firm. Following the acquisition, through a special dividend declaration by the target firm to the equity partners, the invested equity capital is effectively returned to the partners. In some cases the special dividends have effectively eliminated the equity capital originally contributed by the partners. Moody's concern regarding special dividends highlights the need for regulators to retain control of the ability of the utility to upstream cash to the parent/owners.

5. Absence of oversight

Often, a private equity buyout contains no requirements that either the equity firm or the target company maintain any particular financial covenants or adhere to the amortization schedule set out for the transaction debt. Here again, regulators can play a pivotal role in protecting the financial health of a utility buyout by requiring, as a

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[33] The Value Line Investment Survey, *Selection & Opinion*, November, 17, 2006, p. 830.

[34] "Banking on the Big Build," *Public Utilities Fortnightly*, October 2007, pp. 48-53.

condition of approval, just such minimum financial benchmarks and/or debt amortization requirements.

6. Summary and recommendations on the role of debt

Regulators should share the bond rating agency's concerns regarding the use of debt to finance private equity acquisitions. The amount of leverage used in the transaction affects the utility's ultimate financial risk. A reasonable goal is to avoid the loss of an investment grade bond rating for the utility as well as to ensure that transaction debt is reduced according to plan (whether by amortization or by replacement with equity). The regulator should review (and approve) cash flows from the utility to the parent/partners, including any special dividends declared.

B. Ratemaking considerations

We have explained how an LBO increases the utility's financial risk. In planning their acquisition, the equity partners assume that the revenue and cash flow stream of the target utility will remain stable, i.e., regulators will not respond to the buyout by lowering rates. Given our target utility/private equity buyout example set out in Tables 1 and 2, above, this assumption means that the target utility's rates will continue to be based on the pre-acquisition capital structure of 50% equity, 50% debt; and that the income taxes reflected in rates will be the $2.70 shown in the income statement in Table 1. The acquirer's argument for leaving rates unchanged is that no harm results.

The potential for harm does exist. The higher financial risk increases the probability of default in the event of a financial or operating disruption. The "harm" is not immediate or certain, but the potential for detriment to ratepayers and investors is increased. The regulators can offset this additional risk with ratepayer benefit—by recognizing some or all of the acquisition debt when setting rates for the post-acquisition utility. Regulators could also recognize some or all of the tax benefits afforded the equity partners by the use of the additional leverage. True embedded cost ratemaking would require that treatment.

To illustrate this point: Assume that following the buyout, regulators base rates for the utility on the capital structure that is actually supporting utility assets—the new consolidated capital structure, shown in Table 2, consisting of 9% equity capital and 91% debt capital. Also assume that (1) rates reflect the actual costs of debt (both new debt and original debt) and (2), there will be lower income taxes due to the interest payments associated with the increased debt. Assume further that to recognize the substantially higher risk of a 9% common equity ratio, regulators allow the utility a 20% return on equity.[35] A 20% return on $10 equity would indicate a $2.00 net income in our example. With a net income of $2.00, as shown in Table 6 below, operating earnings (and ultimately rates) would decline from the $10.20 of the original utility to $9.15. In

[35] As the percentage of common equity capital declines, its risk increases as does the return investors require for that type of capital.

providing lower rates to customers, the regulator has also limited the profitability of the equity partners to 20%, which is lower than the 30.5% return they would have realized as the result of a "take no regulatory action" stance by the regulator.

Table 6

Ratemaking with Consolidated Capital Structure

	Balance Sheet			Income Statement	
Assets	$100	$10	Equity	Operating Earnings	$9.15
Goodwill	$10	$50	New Debt @ 6%	New Debt Exp.	($3.00)
		$50	Debt @ 5%	Debt Expense	($2.50)
Total	$110	$110		Taxes	($1.65)
				Income	$2.00
		R.O.E. = $2.00/$10 = 20.0%			

Alternatively, the regulator could set post-buyout rates using a hybrid or hypothetical capital structure, which recognizes part, but not all, of the transaction debt. This approach would allow the equity partners a larger proportion of the benefits of the transaction while retaining some benefits for ratepayers. If the regulator (a) elected to set rates using a capital structure consisting of 25% common equity and 75% debt (an equity capital level between the 50% equity of the original utility and 9% of the post acquisition company), (b) recognized the actual tax and debt expense of the combined firm ($1.65 and $5.50, respectively), and (c) allowed the utility a 12% equity return[36], the resulting operating earnings (and ultimate rates) would also decline from their original level, but not as much as shown in Table 6, where the actual consolidated capital structure and cost rates were used for rate setting purposes.

Table 7

Ratemaking with Hybrid Capital Structure

	Balance Sheet			Income Statement	
Assets	$100	$27.5	Equity	Operating Earnings	$9.62
Goodwill	$10	$41.25	New Debt @ 6%	New Debt Exp.	($2.48)
		$41.25	Debt @ 5%	Debt Expense	($2.06)
Total	$110	$110		Taxes	($1.78)
				Income	$3.30
		R.O.E. = $3.30/$27.5 = 12%			

[36] The hybrid equity ratio is higher than in the actual consolidated capital structure and the allowed return is, therefore, lower.

In the situation shown in Table 7, the regulator has recognized some but not all of the transaction debt and interest expense savings. In so doing, the regulator has reduced rates from the level that existed prior to the acquisition, albeit to a lesser degree than shown in Table 6.

A third option for addressing the debt associated with a leveraged buyout of a utility operation is to use a business-as-usual (i.e., non-acquisition) capital structure for setting rates (along with a business-as-usual return on equity), while recognizing that the income taxes paid by the consolidated entity will be less than those the stand-alone utility would have paid. In this scenario, while regulation does not re-direct to ratepayers any increased profit the acquirer might realize through leverage, it does prevent ratepayers from paying through rates for a level of income tax costs that the utility (or its parent) will not incur. That situation is shown in Table 8.

Table 8

Ratemaking With Original Capital Structure And Consolidated Taxes

	Balance Sheet			Income Statement	
Assets	$100	$50	Equity	Operating Earnings	$9.15
		$50	Debt @ 5%	Debt Expense	($2.50)
Total	$100	$100		Taxes	($1.65)
				Income	$5.00
		R.O.E. = $5/$50 = 10%			

In this scenario, the inclusion of the actual consolidated taxes to be paid ($1.65) rather than the taxes calculated on a utility stand-alone basis ($2.70, See Table 1), also causes rates for the post-acquisition utility to be lower than pre-acquisition rates.

All three of the scenarios outlined above in Tables 6 through 8 enable regulators to provide ratepayers some of the benefits gained through the use of leverage in the private equity buyout. All of those ratemaking scenarios reduce the monies flowing to the equity partners, thus reducing the profitability of the transaction from the acquirer's point of view. The cost of protecting ratepayers from risk unrelated to utility operations, or of at least granting ratepayers benefits commensurate with the risks they do incur, is a reduction in acquirer profitability.

Arguments on the other side: Transaction proponents might argue that the regulator should consider, for ratemaking purposes, only the stand-alone metrics (capital structure, taxes) of the regulated portion of the post-acquisition company, because that is the capital structure that would have prevailed absent the merger. Those advocates also hold that unregulated equity partner (parent company) debt ratios and tax rates are extra-jurisdictional and should not be considered in setting rates for the utility.

C. Baseline regulatory requirements

While there are drawbacks to the use of large amounts of debt capital to fund utility operations, there have been successful private equity buyouts of utility operations. Berkshire Hathaway, a public/private partnership bought Mid-American Energy in 2000. In 2006 it purchased PacifiCorp, a utility serving customers in six Western states. In the merger proceeding before the Washington Utilities and Transportation Commission, PacifiCorp committed to the conditions set out below, among others, as part of the merger. These conditions were offered as support for operational and financial separation between the utility and its unregulated parent company. That financial separation has been given the name "ring-fencing" by the financial community.

- All non-utility investments by MEHC [MidAmerican Energy Holding Company – the unregulated parent] will be held in separate subsidiaries;
- PacifiCorp will maintain separate debt ratings, separate financial records and employees;
- PacifiCorp will provide unrestricted access to all written information provided to rating agencies;
- PacifiCorp will not make any distributions to its parent that would reduce its common equity ratio below 40% of capital (excluding short-term debt);
- PacifiCorp will not guarantee any debt of MEHC or its affiliates; and,
- a single-purpose entity (PPW Holdings LLC) will be created between MEHC and PacifiCorp which will have an independent director.[37]

[37] Washington Utilities and Transportation Commission, Docket No, UE-051090, Final Order Adopting Settlement (No. 07), MidAmerican Energy Holdings Company and PacifiCorp, d/b/a Pacific Power & Light Company, Appendix A, February 22, 2006.

These measures provide a reasonable starting point for regulatory action in a private equity buyout in that they attempt to isolate the utility subsidiary from the risks of the parent/acquirer. However, absolute isolation of risks is not possible:

> Standard and Poor's takes the general position that the rating of an otherwise financial healthy, wholly owned subsidiary is constrained by the rating of its weaker parent. The basis for this position is that a weak parent has both the ability and the incentive to siphon assets out of its financially healthy subsidiary and to burden it with liabilities during times of financial stress. The weak parent might also have an economic incentive to filing the subsidiary into bankruptcy—if the parent itself were forced into bankruptcy—regardless of the subsidiary's "stand-alone" strength. Experience suggests that insolvent corporations will often jointly file with their subsidiaries—even those subsidiaries not themselves experiencing financial difficulty.[38]

> In Fitch's view, ring-fencing techniques rarely provide total insulation of a U.S. utility from problems relating to an insolvent parent. Furthermore, even if affiliates are segregated in numerous ways, the presence of a single important unifier, such as a large intercompany loan or an intercompany supply contract critical to continuing operations, may nullify all other ring-fencing efforts.[39]

The conditions set out above illustrate the primary goal of any effort at ring-fencing: to provide prohibitions, reviews and/or conditions that will limit inter-company subsidies, cash transfers and other opportunities whereby a weaker parent/acquirer can impair the financial health of the regulated subsidiary. Elaboration on each condition follows:

1. Corporate separation of utility and nonutility businesses

The parent, if it owns unregulated operations in addition to the utility, will organize those unregulated operations into separate subsidiaries. While that corporate structure does not prevent cash flows between the companies it does cause the financial parameters of the unregulated operations to be separately stated (income statement, balance sheet, cash flow statement) and tracked. If that were not a requirement of the merger, and the unregulated investments were simply divisions of the parent/acquirer there would be no way to quantify financial data regarding those riskier, unregulated operations.

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[38] Standard & Poor's Ratings Direct, Ring-Fencing a Subsidiary, October 19, 1999, p. 1.

[39] Fitch Ratings, Corporate Finance, Rating Linkage Within U.S. Utility Groups: Ring-Fencing Mechanisms, Utilities, Holding Companies and Affiliates, April 8, 2003, p. 1.

2. Separation of corporate reporting

Mid-American assured regulators that the regulated utility would retain its identity by maintaining its own separate reporting, financial records and employees and its own bond rating. In order for regulators to track the financial health of the utility, it must be a separate subsidiary with its own financial records. Separating utility employees from those of the parent/acquirer also provides more accurate analysis of utility operations. Maintaining its own bond rating and, thereby, its own identity is also important for a capital-intensive company like a utility because of the continuing need to raise capital to meet public service requirements. Although the utility's bond rating and financial risk are affected by that of its parent/acquirer, it is important that the utility's separate identity be maintained publicly.

3. Regulator access to information about subsidiary and parent

The post-acquisition utility promised to provide the regulator all written information provided to bond rating agencies. That information is important because it typically includes very detailed information regarding the company's service territory, customer mix, financial projections, generation facilities and purchased power obligations, workforce projections, pension obligations, potential legal issues and the like. All of that information would be available in an S.E.C. filing, but not with the level of detail provided to bond rating agencies nor with projections for the future. Those data can be especially valuable if the utility is taken private and does not publish the information required by the S.E.C.

The regulator, ideally, should also have access to the financial records (income statement, balance sheet, cash flow statement) of the private equity firm (the acquirer) so that the total risk to the utility can be accurately assessed. If the merger were between two publicly traded firms, the regulator would have that information through S.E.C. reporting. As explained in Part V, above, private firms are not required to publish such information, although they must have it internally to manage their firm. The regulatory body therefore should condition merger approval on having continuing access to financial data about the acquiring private equity firm, at a level of detail comparable to what would be available if the firm were publicly traded.

4. Prohibition on access to utility cash

The utility agreed that it would not make any dividend or other cash distributions to the unregulated parent that would cause its utility subsidiary common equity ratio to decline below 40% of total capital. While the ability to limit dividend distributions and cash flows to the parent from the utility helps protect the financial health of a utility, the offer simply to maintain a certain common equity ratio on the financial books of the utility subsidiary is not sufficient. As we saw in Tables 3 through 5, even though our target utility showed a utility-only equity ratio of 50% on its books, that equity is

financed with 17% parent/acquirer equity and 83% debt.[40] Thus the amount of equity supporting what appears to be 50% equity on the subsidiary's balance sheet is actually much less. Moreover, it would be a simple matter for the subsidiary to declare a special dividend to the parent, while the parent issued additional debt in like amount, with the proceeds then injected into the subidiary to maintain the subsidiary capital structure equity ratio. In that scenario the utility's equity ratio is maintained but cash is transferred to the parent/acquirer while the parent/acquirer finances even more of the utility equity with debt.

A more direct way for regulators to monitor cash flows between the utility and the parent/acquirer is to require the utility to notify the commission prior to such a transfer, or request permission to do so. If the regulator believed the funds transfer to be problematic, it could prohibit or condition the transfer. The alert the regulatory body, the more the financial risk separation between the entities.

The primary means of transferring cash from a subsidiary to a parent is through dividend payments. Monies can be transferred by other means, such as inter-company loans and/or affiliate transactions. If the regulated subsidiary guarantees debt or other obligations of the parent, that guarantee represents a potential for cash flows out of the utility if the parent defaults on its obligations. MidAmerican committed that the utility would not guarantee any debt obligations of the unregulated parent or any of its affiliates. That commitment should be a minimum requirement of any buyout or merger: the utility should not guarantee any additional debt (debt in excess of the transaction debt) of the parent or other subsidiaries.

Corporate money pools also offer opportunities for regulated subsidiaries to provide cash to unregulated affiliates. Holding companies with several subsidiaries often have "money pools," a cash management facility where subsidiaries deposit or borrow cash on a daily basis. Such money pools provide a linkage between the financial operations of regulated and unregulated firms in the holding company. For example, a cash-rich utility operation could lend the holding company money pool $50 million. A cash-poor competitive affiliate could then borrow that same $50 million from the money pool, at a short-term debt rate. In effect, the regulated utility is lending money to the unregulated operation. Such a transaction would not violate a prohibition against utility loans to affiliates if the utility's $50 million contribution is be characterized as "participating in the corporate money pool" and not specifically lending to any entity directly. Such a characterization would not be untrue factually but it would be misleading practically, because it would mask the actual financial linkage of the regulated and unregulated subsidiaries.

[40] Table IV shows that the parent-only capital structure of the acquirer contains $10 equity and $50 new debt, and the total capital = $60. The parent-only equity ratio is $10/$60 = 17% and the parent-only debt ratio is $50/$60 = 83%.

5. Single purpose entity with a single independent director

The final criterion set out in the MidAmerican/Pacificorp ring-fencing plan calls for a "single purpose entity" (SPE)—a corporate layer placed between the parent company and the utility subsidiary. That SPE has an independent director unaffiliated with the parent, incurs no debt, cannot merge or consolidate with any other corporate entity, and cannot be dissolved as long as the parent and utility ownership relationship persists. The sole function of the additional corporate layer entity, according to Standard & Poor's, is to prevent the parent company from filing the subsidiary into bankruptcy without the approval of the independent director of the SPE.[41] The creation of an SPE between MidAmerican Energy Holdings Company (the unregulated parent holding company) and its regulated utility subsidiaries has been a factor in supporting a higher bond rating for the subsidiaries than for the unregulated parent holding company, which has a more leveraged capital structure.[42]

6. Non-financial considerations

This portion of our paper has focused on a private equity buyout's financial implications. The reviewing regulator should review non-financial aspects as well. The utility should sustain service quality standards, and all construction and maintenance schedules.

The regulator may elect not to approve a leveraged private equity buyout of a utility. If the regulator does decide to approve the buyout, a list of conditions for approval of such a transaction is set out in the final section, below. These conditions are designed to lessen the risk to the acquired utility and its ratepayers and to give the regulator the ability to protect the utility's financial health.

D. Conditions for approval.

Regulators should attempt to establish the following conditions prior to approval of a private equity buyout of a public utility.

1. Limit transaction leverage: The overall riskiness of the transaction is reduced if less debt and more private partner equity capital is used to finance the acquisition. The regulator should establish a minimum equity contribution by the acquirer; below which the additional risk is not worth any benefit from the acquisition. A 20% equity contribution is better for the long-term health of the utility than 15%, 30% is better than 20%, etc.

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[41] Standard & Poor's Ratings Direct, Ring-Fencing a Subsidiary, October 19, 1999.

[42] For example, MidAmerican Energy Holding Company's latest S.E.C. Form 10-K indicates a bond rating for the parent of "BBB+", while PacifiCorp and MidAmerican have bond ratings of "A-".

2. Separate subsidiaries: The utility should be a separate subsidiary with its own books and records. If the acquiring firm owns other operations, they should also become separate subsidiary corporations with separate books and boards of directors. Regulators should have access to all financial data of subsidiaries whose operations could affect the utility's financial health.

3. Separate utility bond rating: The utility should maintain its own bond rating. The regulators should have access to all of the detailed written material provided by the utility to the bond rating agency(ies), including financial projections. If the acquirer also maintains a bond rating (unlikely in a private equity buyout), regulators should have access to those data as well.

4. No debt guarantees by the utility: The utility should not be the guarantor of any debt issued by the private equity firm/acquirer or by any of the other subsidiaries owned by the acquirer. Regulatory approval should also be sought for utility issuances of debt, and preferred stock.

5. Single purpose entity to prevent parent-induced bankruptcy of the utility: A single-purpose corporate entity between the acquirer and the utility should be established. That entity will conduct no business of its own or issue any debt, will have an independent director that is not affiliated with either the acquirer or the utility, and exists solely to prevent an attempt by the acquirer to file the utility into bankruptcy.

6. Cash Flow control: Regulators should establish authority to monitor all cash flow transactions between the utility and its acquirer or other subsidiary owned by the acquirer. Such transactions include dividends, payment for goods and services received, assignment of receivables. Regulatory approval should be required for any special dividend or cash transfer, or any normal dividend that is more than 10% higher than the prior year's average.

7. Corporate money pool: The utility should not participate in corporate money pool short-term borrowing/lending arrangements, unless participation affords the utility substantially lower costs of short-term debt than it is able to achieve on a stand-alone basis.

8. Regulatory treatment of consolidated debt and taxes: Prior to the acquisition, the regulatory body should determine the manner in which it intends to treat, for ratemaking purposes, transaction debt (i.e., include some or all of it in ratemaking capital structure) and consolidated taxes (i.e., capture some or all of consolidated tax savings in ratemaking cost of service). Capturing some of the private equity firm's gain from either

leverage or the related tax savings can change the economics of the transaction.

9. Resource plans: Following the acquisition, the utility should maintain current integrated resource plans to meet future demand; or, if changes are to be made, they should be subject to regulatory review.

10. Service quality: Following the acquisition, the utility should maintain current service quality standards, or, if changes are to be made, they should be subject to regulatory review.

E. End Note

In this paper, we have described mergers and acquisitions, the reasons why corporations combine, and the ways in which those combinations are undertaken. We have focused our analysis particularly on private equity buyouts of public utilities. In so doing, we have identified the different parties involved in a private equity buyout of a utility, examining their private interests in such transactions, and identifying where those private interests may conflict with the interests of the public. Finally, we have suggested methods and requirements that can address public/private interest conflicts where they occur.

How will regulators respond to the purchase of regulated utility operations by private equity firms that will occur in the future, in order to align the interests of both investors and ratepayers with the public interest in the availability of reliable utility service at the lowest reasonable cost? While the answer to that question is unclear at this point, we hope this paper has provided a framework for evaluation and analysis of a private equity buyout of a public utility and a means by which the financial health of a utility subject to such a transaction can be better assured.