Utilities Industry Council Topic for 2006

Slide 1: The State of the Utility Business in a Post-Public Utility Holding Company Act (PUHCA) Environment

On August 8, 2005, President Bush signed into law the Energy Policy Act of 2005. Among other provisions, the Energy Policy Act repealed the Public Utility Holding Company Act – or "PUHCA" - thereby removing a 70 year ban on multi-state utility holding companies. This means that large parent utility corporations made up of smaller subsidiary utility corporations can now conduct business across multiple states.

Why is PUHCA's repeal important? While the long-term results of PUHCA's repeal remain unknown, industry experts expect dramatic consequences for the utility industry. With multi-state utility holdings no longer restricted, the Utilities Industry Council anticipates that a number of gas, electric, and water companies will seek to merge with – or buy – utility companies in states other than their own. Additionally, increasing market pressures on utility companies are expected to prompt mega-mergers, as companies attempt to create economies of scale and potential cost savings.

Thus, the utility industry is experiencing many changes in the post-PUHCA environment. Attempts at utility mergers and acquisitions have been met with mixed results. Regulatory power has moved from the Federal Energy Regulatory Commission to individual state utility commissions. State regulators have enacted different standards regarding proposed acquisitions and merging companies have promised varied levels of ratepayer savings.

Clearly, however, the repeal of PUHCA has forced companies to rethink their growth strategies. The possibilities for multi-state utility holdings and mega-mergers have created new opportunities for profit in the utility industry. Only time will tell to what extent these opportunities are realized.

Slide 2: The Public Utility Holding Company Act (PUHCA) became Law in 1935 and was Repealed Effective February 2006

In order to understand the current impact of PUHCA repeal on the utilities industry, it is important to get a little background on the history of PUHCA.

Utility holding companies experienced rapid expansion in the early 1900's. Fueled by growth in the electric and gas industries and financed by the developing Wall Street establishment, a handful of large interstate holding company systems took over the utility market.

The Federal Trade Commission, wary of the high concentration of utility industry power in the hands of a few, undertook an extensive study of the public utility industry in 1929. Not surprisingly, the study uncovered a myriad of utility industry abuses facilitated by the holding company's pyramidal structure.

Holding companies bought other holding companies - - creating up to 10 layers of ownership between the utility subsidiary and its holding company. These bureaucratic layers made it difficult to determine the true assets and liabilities of the company. Any and all attempts to assess the holding companies' financial states were highly speculative and rarely accurate. Unregulated, holding companies began to abuse their power. Manipulating market rates and forcing subsidiaries to buy supplies from affiliates at exorbitant above-market prices, holding companies made it virtually impossible to trace their deceptive inter-affiliate transactions. Investors were defrauded, subsidiary companies were forced to pay excessive prices for services and in the end, energy prices were grossly inflated.

However, states were unable to effectively regulate these multi-state holding companies. At that time, many states did not have a utility-related regulatory structure in place, such as a state Board of Public Utilities or a state Public Utilities Commission. Moreover, the Supreme Court considered state regulation of multi-state holding companies to be a violation of the Commerce Clause of the Constitution.

How, then, could the U.S. government remedy holding company abuses? In 1935, Congress finally passed the Public Utility Holding Company Act.

PUHCA affected holding companies in two major ways. First, PUHCA mandated the simplification of the utility holding company structure. By imposing an "integration requirement," PUHCA required holding companies to own only energy-related companies in discrete geographic areas. No longer could one holding company control utility subsidiaries in two different states. Second, PUHCA authorized the Securities Exchange Commission as the main overseer of utility holding companies.

The changes enacted by PUHCA revolutionized the utility industry. Gone were the days of secretive corporate accounting and customer exploitation. In their place was a new era of extensive reporting and accounting requirements; the government was now thoroughly regulating all utilities business.

Why then, was PUHCA repealed in the Energy Policy Act of 2005?

To put it simply: times change. In the 70 years since PUHCA's inception, numerous regulatory controls, including Federal energy laws and Federal securities laws, have been enacted. In Congress' eyes, these new laws "more than adequately" protect consumers and ratepayers from corporate abuses of power. Therefore, PUHCA is no longer necessary.

On top of their desire to eliminate unnecessary regulation, Congress determined that repealing PUHCA would encourage competition in the energy industry. New participants would

have the opportunity to engage in the utility market, thereby stimulating investment. With enhanced market competition, utility prices would decrease and consumers would benefit.

Understandably, PUHCA's repeal initially concerned many consumer advocates and industry groups. The repeal, they worried, would allow utility companies to finance multi-state mergers and acquisitions by increasing energy rates to utility customers.

Congress took these consumer concerns to heart when repealing PUHCA. To protect consumers from paying unfair rates, Congress called for more transparency in holding companies' accounting – specifically, greater Federal and state access to company records, books, and ratemaking standards.

Thus, in passing the Energy Policy Act of 2005 and repealing PUHCA, Congress attempted to open up the utility industry to free market competition while, at the same time, protecting consumers from corporate exploitation.

PUHCA was repealed in August, 2005 and went into effect in February, 2006.

Slide 3: Post (PUHCA) Merger and Acquisition Activities Amongst Utilities to Date

Since February, utility companies have begun to investigate newly-possible opportunities in corporate restructuring. Interested in creating larger service areas, some utility holding companies have attempted to capitalize on the new regulatory environment by merging or acquiring other utility companies.

As of December 2006, there have been six major attempts at mega-mergers in the utility industry.

1. Duke Energy Corp. and Cinergy Corp.

   In May 2005, Duke Energy Corp agreed to a $9 billion acquisition of Cincinnati-based Cinergy Corp. The merger would form a company with about 5.4 million customers in Ohio, Kentucky, Indiana, North Carolina, South Carolina and Ontario Canada with assets totaling more than $70 billion.

   Duke Energy and Cinergy successfully completed their merger on April 1, 2006, after receiving the final regulatory approval needed to seal the deal. Impressively, the merger received all regulatory and shareholder approvals in less than 11 months.

2. MidAmerican Energy Holdings Company and PacifiCorp Holdings Inc.

   In March 2006, MidAmerican Energy Holdings Company, an Iowa-based subsidiary of the investment company Berkshire Hathaway, acquired PacifiCorp Holdings Inc., a wholly-owned subsidiary of ScottishPower. The sale, which was valued

at $9.4 billon, was approved by state utility commissions in Utah, Wyoming, Idaho, California, Oregon, and Washington.

3. Exelon Corporation and Public Service Enterprise Group

Chicago-based Exelon Corporation announced it planned acquisition of Newark, New Jersey-based Public Service Enterprise Group (PSEG) in December 2005. The proposed merger was valued at $17.8 billion. Although the FERC, the US Justice Department and several state regulatory bodies quickly signed off on the deal, Exelon and PSEG were unable to come to terms on a settlement under which the New Jersey Board of Public Utilities would allow the merger.

In July 2006, Exelon and PSEG submitted what they called their "last and best" settlement offer – a package that included $600 million in rate relief, an electric rate freeze, tax benefits to the state, and promised savings from better nuclear operations. They valued the entire package at $1.46 billion. In August, New Jersey regulators countered by asking for more than $200 million in additional rate relief and the sale of two more peaking power plants than the companies planned to sell. Exelon and PSEG were unwilling to meet New Jersey regulators' increased demands and the merger collapsed.

4. Constellation Energy and Florida Power and Light

FPL Group Inc. (the parent company of Florida Power and Light utility), announced plans to acquire Baltimore-based Constellation Energy (CEG) in December 2005. By merging, FPL Group hoped to create a top-tier nuclear generator and to expand their services away from Florida. The deal was worth about $11 billion.

By October 2006, however, FPL and CEG were forced to terminate their planned merger, citing uncertainty of regulatory and judicial approval in Maryland.

5. National Grid PLC and KeySpan Corp.

In August 2006, shareholders of National Grid PLC, the London-based distributor of natural gas and electricity, "overwhelmingly" approved the acquisition of KeySpan Corp., the Brooklyn-based utility that generates most of Long Island's electricity and provides most of its natural gas. The merger was valued at $11.8 billion.

Although federal regulators approved the National Grid/KeySpan merger in October 2006, the proposed merger is currently pending final approval from the New Hampshire and New York public utilities commissions. If approved, National Grid would acquire KeySpan for $7.3 billion and assume $ 4.5 billion of debt.

6. WPS Resources Corp. and Peoples Energy Corp.

Green Bay-based WPS Resources Corp. announced their merger with Chicago-based Peoples Energy Corp. in July 2006. The merger is valued at $9.2 billion.

The transaction is expected to go through in the first quarter of 2007, pending the approval of the Illinois Commerce Commission, the Public Service Commission of Wisconsin, and the FERC.

Slide 4: Regulatory Hurdles to Post-PUHCA Utility Mergers and Acquisitions…The Shift in Balance of Power from FERC to State Regulation

Why have there only been six major attempted utility mergers? Reluctance to initiate the creation of multi-state utility companies may be partially attributed to new regulatory hurdles: much of the regulation of utility companies has shifted from the Federal Energy Regulatory Commission (FERC) to individual state commissions.

Endowed with new regulatory powers, state commissions are creating new standards for utility mergers. And, importantly, these new standards are not uniform across states. This means that while the acquisition of an Ohio-based utility company might be deemed acceptable by Ohio regulators, the acquisition of a similar utility company might be rejected in New Jersey. Because all attempted utility mergers and acquisitions must face a new, and sometimes unknown, slew of regulatory hurdles, holding companies remain hesitant to merge.

However, not only are holding companies wary of the new regulatory environment, so too are utility customers and employees. Concerns regarding customer rates, service reliability, employee benefits, and the division of merger savings are only beginning to be addressed by state utility commissions.

Customer Rates

How have the proposed mega-mergers of 2006 attempted to deal with the issue of customer rates?

Since PUHCA's repeal, several state public service commissions have considered proposed mergers' effects on customer rates to be a key factor in deliberating whether or not to allow the merger. In New Jersey, regulators utilized a "positive benefits standards of review" in evaluating proposed acquisitions. In effect, this means that holding companies seeking to merge must prove that their merger offers positive benefits to all parties involved, including customers, employees, and the state. In assessing the "positive benefits" of a proposed merger, New Jersey regulators named the merger's effect on customer rates to be a key factor.

Regulators also placed importance on customer rates in merger deliberations in Ohio. The Public Utilities Commission of Ohio determined that it would approve mergers only if the

mergers would “result in the provision of adequate service for a reasonable rate, rental, toll, or charge.”

South Carolina also considered customer rates in assessing the Duke Energy and Cinergy merger. Assessing the merger on the basis of whether or not the merger was in the “public interest,” the Public Service Commission of South Carolina determined that to gain commission approval Duke Energy would be forced to reduce its South Carolina retail base rates for one year.

Like South Carolina, the Idaho Public Utilities Commission decided that they would approve a merger or acquisition only if the transaction was in the “public interest.” And, in evaluating the MidAmerican/PacifiCorp acquisition, the Idaho commission based their approval on the requirement that customer rates would not increase as a direct result of the transaction.

Service Reliability

What will utility mega-mergers mean for service reliability?

The issue of service reliability has also factored into state commissions’ approval of mergers and acquisitions. In New Jersey, the Board of Public Utilities explicitly acknowledged the importance of continued service reliability for consumers, judging the Exelon/PSEG merger based on the proposed merger’s ability to provide “safe and adequate utility service.”

Similarly, in assessing the Duke/Cinergy merger, the Public Utilities Commission of Ohio will require merger applicants to make certain expenditures if, after the merger and in each year through 2010, service reliability results in a noticeable degradation in performance. The Commission went on to say that any decline in electric distribution reliability would be unacceptable and, if the Commission found reliability to be diminishing, it would have the authority to take the appropriate actions.

Impact on Employees

The expected increase in utility mergers will affect not only utility customers, but also utility employees. Mergers and acquisitions often force job losses and/or wage battles between labor and management. However, as state commissions review proposed mergers, several have taken employee’s concerns into consideration.

In New Jersey, regulators determined that if, as a result of a proposed merger, a utility company would be unable to continue to provide employees with their current pension benefits, the Board would reject the proposed merger.

In situations where state commissions did not explicitly delineate a proposed mergers responsibilities to employees, several merging companies have privately ensured continued job security for workers. For example, prior to their merger with MidAmerican, PacifiCorp assured the California Public Utilities Commission that it had no plans to reduce its workforce as a result

of the acquisition. Similarly, PSEG guaranteed full job security to all workers if their merger with Exelon was approved.

Labor seems to be approaching the expected increase in utility mergers and acquisitions in a pragmatic manner. In a press release issued by IBEW International President Ed Hill on November 1, 2006, Mr. Hill suggested that if the merger between Florida Power and Light and Constellation Energy Group had been approved, the merger "could have ultimately been positive for both companies and their workers." Mr. Hill went on to say that "mergers in the utility industry …can be beneficial if conducted with transparency and regard for the public interest."

Division of Merger Savings

Another important issue in the post-PUHCA environment has been the division of merger savings, that is, the distribution of money that holding companies have saved as a result of the merger. For example, perhaps a post-PUHCA merger allows a utility company to have access to a former competitor's new plant. As a result of this access, the utility company is able to sell an older, no-longer-useful plant. This sale would provide the company with a significant amount of new money. Imbued with new regulatory authority, some state commissions have decided to regulate this merger savings.

In Ohio, the Board approved the Duke/Cinergy merger under the auspices that the holding company would share expected merger savings with retail customers in the form of a rate credit, regardless of whether or not the savings were actually achieved.

Similarly, in South Carolina, the Commission stipulated that Duke must finance reductions in retail base rates for all South Carolina customers from the money saved as a result of the merger.

The New Jersey Board of Public Utilities also found the distribution of merger savings to customers to be a compelling issue in evaluating mergers. In fact, when Exelon and PSEG proposed using their merger savings to provide New Jersey customers with $600 million in rate relief, the New Jersey board demanded that the companies increase their rate relief to $800 million. In requiring this increased dispersion of merger savings, the New Jersey board effectively rejected the Exelon/PSEG merger. Unwilling to pay the full $800 million, the Exelon/PSEG merger fell through.

Slide 5: Mixed Results for Utility Mergers and Acquisitions to Date

As I have alluded to, attempts at utility mergers and acquisitions have encountered mixed results. Of the six attempts at major utility holding company mergers, two have succeeded, two have failed, and two are awaiting approval. In attempting to draw conclusions from the mixed results of the attempted mergers, one trend remains clear: the lack of standardization among

different state utility commissions. The results of the six attempted mergers were beholden to different utility commissions with different standards of evaluation and different political environments.

Duke Energy and Cinergy successfully completed their merger in the spring 2006. The state commissions in Ohio, South Carolina, and North Carolina individually determined that the Duke/Cinergy merger would serve the public interest. In Ohio, the state commission even forced the companies to prove that their merger would “promote public convenience and result in the adequate service for a reasonable rate, rental, toll or charge.”

On top of serving the public, however, Duke Energy/Cinergy was forced to ensure a number of consumer protections. The North Carolina Commission’s approval, for example, included an order that stipulated 74 regulatory conditions and a code of conduct meant to protect the state’s retail ratepayers. Among the conditions of the merger, Duke Power must implement a one-year gradual decrease in rates by $117.5 million. Additionally, Duke will be required to contribute $12 million to a variety of environmental and economic development programs. Commission plans to initiate an investigation to determine whether Duke Power’s existing rates and charges are unjust and unreasonable and will require the company to file a general rate case or show cause why the company’s existing rates and charges are reasonable.

Like the Duke Energy/Cinergy merger, the MidAmerican/PacifiCorp merger was determined to serve the public interest by state utilities commissions. The Washington Utilities and Transportation Commission found the sale to be consistent with the public interest because it included a comprehensive set of commitments that emphasized important public service obligations including customer service, safety, system reliability, and use of energy efficiency and conservation.

While Duke Energy/Cinergy merger and the acquisition of PacifiCorp by MidAmerican were able to comply with the public interest concerns and regulatory stipulations of the Ohio, South Carolina, North Carolina, Utah, Wyoming, Idaho, California, Oregon and Washington state utility commissions, other proposed mergers did not experience the same success.

In both the attempted Exelon/PSEG merger and the FPL/CEG merger, utility holding companies ran up against more discerning state commissions.

The New Jersey Board of Public Utilities was the last and highest hurdle to the Exelon/PSEG merger. Establishing precedent, the Board decided to judge the merger according to a “positive benefits” standard, not simply a “no harm standard.” During the proceedings, many raised fears that the merger would give the proposed Exelon Electric & Gas too much market power. They claimed the merger would let the company dominate the wholesale market in the region, and raise prices for customers throughout the state. Thus, when the Commission decided that it would approve the merger only if Exelon and PSEG decreased customer rates and agreed to sell two additional power plants, the merging companies determined that the Board’s demands were “insurmountable” and the merger collapsed.

The Maryland utility commission forced the dissolution of the Florida Power and Light/ Constellation proposed merger. FPL became caught up in Maryland politics over Constellation's Baltimore Gas & Electric's plans to raise electricity rates. FPL and Constellation proposed their merger at a time when the rate caps in Maryland were due to expire and rate increases of as much as 72% were slated to take effect. In this contentious climate, FPL and Constellation's proposed merger was met with predictable hostility from consumer advocates and regulators. Furthermore, Constellation executives attempted to hide the full nature of the large compensation packages they would have received in the merger. The public was outraged and the merger failed.

What can be said in summation regarding the utility industry post-PUHCA? More than anything, the results of PUHCA's repeal have been inconclusive. While two mega-mergers were successfully completed, two have failed miserably, and two await regulatory approval. Perhaps we can attribute these mixed results to the lack of uniformity in state regulatory standards. With the new possibility of multi-state holding companies, it seems likely that we will continue to see attempts at multi-state mergers and acquisitions. However, the completion of these attempted mergers remains indeterminate. The utility industry is poised for change and we must await it discerningly.

Slide 6: Now Tom Schneider will Report on…

- **What steps, if any, utility companies are taking to preserve their independence in response to the repeal of PUHCA**
- **Union reaction to mergers and acquisitions amongst utilities**
- **His perspective about the future of the utility industry in a post-PUHCA world**