Balancing M&A Benefits

Achieving Equitable Outcomes

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tilities consolidation since 1995 is well chronicled, yet its accomplishments are often unappreciated. Prior transactions have slowed customer rate growth, strengthened utility financial capacity, and enabled capital investment in grid hardening and modernization, creating benefits inuring to shareholders and customers alike.

While future mergers and acquisitions will continue this focus, an even more valuable benefit exists – accelerating the transition to a net-zero world through synergies deployment – but only if convincing regulatory plans are created by utilities, and only if equitable merger outcomes can be realized between shareholders and customers.

When the next U.S. utility stock-for-stock merger or acquisition occurs, company managements will again need to decide how to pursue its approval by state regulators, particularly how to balance risks, synergies, costs-to-achieve, and short- and long-term benefits among key stakeholders.

On one hand, utilities and shareholders are intent on ensuring that transaction requirements and outcomes are not one-sided. Regulators and intervenors are equally resolved to deliver and safeguard meaningful rate-level impacts and other benefits to customers.

This divergence in perspective reflects natural positions of utilities and regulators over value creation and benefits realization and creates an obvious conflict in priorities and expectations between the two. It frames the pivotal challenges to achieving a fair and equitable outcome for benefits distribution between shareholders and customers.

Four critical transaction components define success in a merger – bid prices, net synergies (after costs-to-achieve), regulatory approvals, and integration execution – and all work in concert. But the most influential item emerging from a merger application approval process is the final regulatory order that defines how net synergies distribution will occur and whether the merger outcome yields equitable or asymmetric results.

In many prior transactions, desired and realized outcomes for net synergies distribution were closely aligned. Regulatory approval decisions were largely balanced between shareholders and customers, providing symmetrical near-term outcomes (such as fifty/fifty sharing of net synergies). This result blended the principle of recognition of shareholder-assumed risks and costs with its counterpart of ensuring customers directly receive tangible benefits from a transaction.

More recently, these principles have become skewed, and net synergies sharing outcomes have become more asymmetric, with most benefits inuring to customers and little or no recognition of shareholder risks in underlying decisions. This outcome diminishes the risks and costs shareholders bear in underwriting a proposed transaction, expecting fair regulatory outcomes, enabling merger benefits to be created, and counting on management's capability to effectively execute through the regulatory approval process and beyond the close.

This observable pattern of risk and reward frames a critical part of the challenge to achieving equitable merger outcomes for companies and regulators to jointly solve.

Traditionally, utilities file an application for merger approval that provides the case for the transaction (such as its logic, structure, financing, benefits, impacts, protections, and commitments). The company's regulatory plan – how much, how, and when it proposes to distribute available benefits – is a centerpiece of this application and forms the basis for a substantial portion of the subsequent engagement around the merits of the application.

While each of these application elements is an essential component of the whole, individually, they do not reflect all critical dimensions that comprise a comprehensive and integrated regulatory plan. Future regulatory plans need to model their approval applications to provide more comprehensive and compelling information to regulators that frame transaction relationships that matter (such as risks and benefits, synergies and costs-to-achieve, decisions and impacts, and short- and long-term results).

To high-grade future approval applications, utilities need to reassess their philosophies, models, and approaches to design of regulatory approval strategies and plans. Plan modifications and enhancements to address continuing adverse trends need to result in thoughtful foundational principles, clear risk articulation, broad value demonstration, expanded empirical evidence, creatively crafted sharing, responsive alternative offerings, and innovative issue resolution approaches.

If utilities are successful in making the case for equitable

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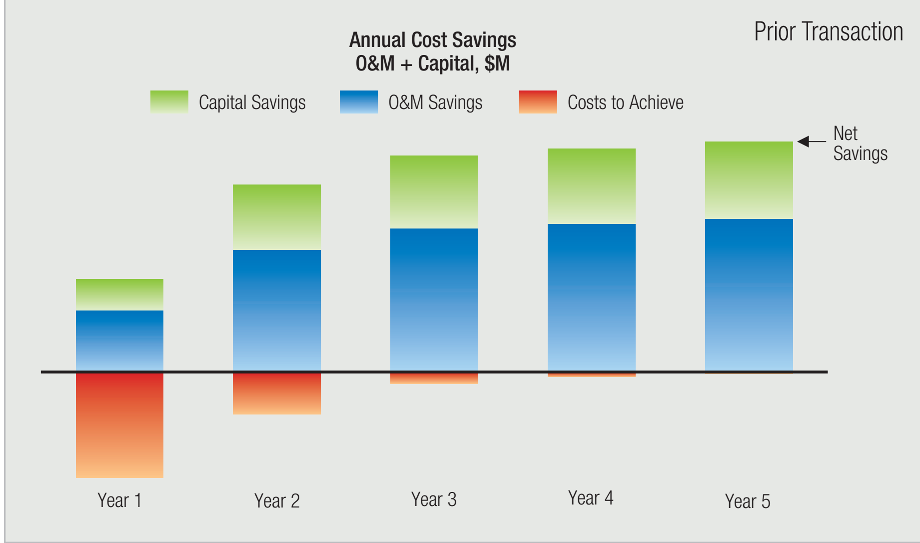


Fig. 1 Typical Net Savings Realization

outcomes among stakeholders, value destruction can be avoided, sustained customer benefits enjoyed, and the transition to net-zero accelerated.

Benefits and Costs

Utility merger transactions produce a wide range of tangible and intangible benefits from combination. While merger synergies are the most visible transaction element, they are often complemented by other factors, such as new assets, accelerated infrastructure, economic development, job creation, community funding, new product offerings, improved system reliability, increased security of supply, enhanced environmental outcomes, employee opportunities, and targeted forms of customer protection and bill relief.

Conventional merger synergies result from avoidance of duplication and overlap, capture of economies of scale, and avoidance of related capital expenditures. These sources shape the core value elements of a combination between two utilities and are easily discernable, estimable, and quantifiable with reasonably good precision. Reducing operating and maintenance (O&M) expenses achieves lower future rate levels and provides a recurring yardstick for assessing ongoing merger benefits.

Typical merger synergies are estimated for a five-year period, sometimes longer if distinctive future events are expected. These multiyear values can be specifically determined and linked directly to decisions made by management. These merger synergies ramp up over a three-year period to reflect integration progress, then usually escalate with inflation. See Figure 1.

However, combining two companies to produce expected merger benefits does not occur without significant out-of-pocket costs to structure, finance, approve, integrate, and execute a transaction so that available synergies and other benefits can be attained. These costs start well before an agreed transaction is ever announced and continue for years after deal closing.

Consequently, merger synergies and costs to achieve do not move in tandem, as synergies realization substantially lags costs-to-achieve incurrence, while the companies take time to integrate them. Net synergies turn positive in the second year post close, begin to grow through post-close implementation, and then continue into perpetuity after year three while costs to achieve dissipate.

With this pattern, it's easy to see how dichotomous outcomes between shareholders and customers emerge immediately at transaction close and last into succeeding years. The timing lag between synergies realized and costs incurred creates unavoidable risks and a skewed outcome between shareholders and customers from day one post close, even before synergies distribution begins.

This observable pattern of risk and reward frames a critical part of the challenge to achieving equitable merger outcomes for companies and regulators to jointly solve.

Shareholder and Customer Risks

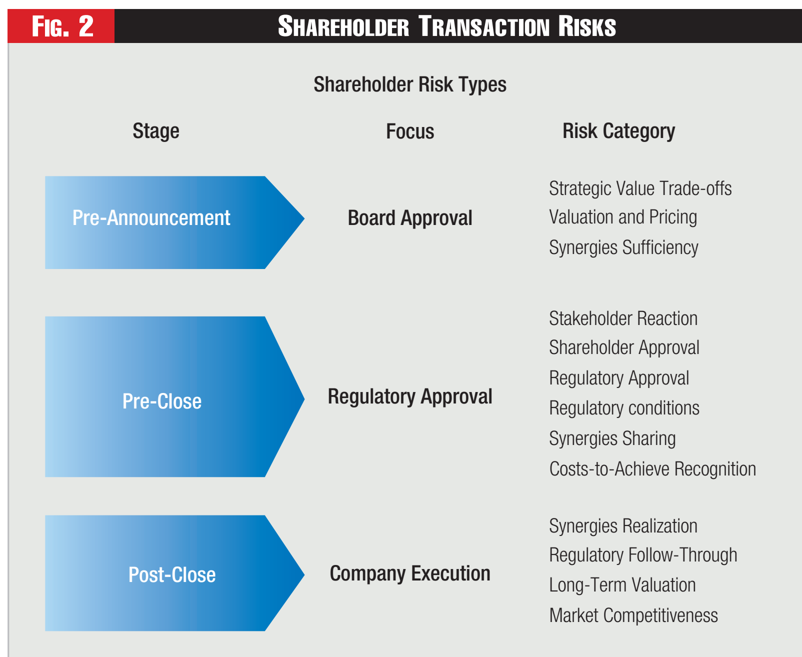
When utilities pursue mergers and acquisitions, they do not control the nature and impact of regulatory decisions. Similarly, utilities do not carry a perception that they will receive the exact outcomes

they seek. However, they do have an expectation that both they and their customers will be treated fairly, and that merger approval will not result in value destruction to their companies.

While there is no explicit regulatory compact that applies to the outcomes of merger transaction approval proceedings – like that existing in traditional rate case proceedings – conventional thinking is that both shareholders and customers need to be treated fairly through decisions reached by regulators.

Shareholders need to be recompensed for the risks they accept to achieve a successful transaction outcome, while customers need to benefit for their previous support of higher O&M costs pre-merger.

Fig. 2 Shareholder Transaction Risks



Source: Flaherty, Thomas J. *Roll-Up: The Past, Present, and Future of Utilities Consolidation.* EY-Parthenon analysis.

Shareholders are vital to the accomplishment of a proposed merger – they provide the capital, assume the market risk, and rely on management's ability to execute. They recognize that the role they play in enabling a transaction to occur does not convey an entitlement to a particular outcome. Shareholders are experienced with regulatory processes and understand the vagaries of multi-intervenor, multistate proceedings.

But shareholders still expect the regulatory order will balance interests in a manner that incents capital commitment to fund a transaction and provides tangible impacts that either lower current rates or slow the rate of future increases.

From a shareholder perspective, this group incurs risks throughout the transaction lifecycle, from pre-announcement, through pre-close preparation and approval, and beyond close. These three transaction time frames include a wide range of individual risks spanning from deal logic and early financial structuring to application approval process fairness and equity to ongoing market, financial, and operating success.

See Figure 2.

These risks are numerous and impactful, if not adequately recognized and effectively addressed. Even before a deal is struck, shareholders assume that management has identified the right target to pursue, and the proposed transaction produces strategic value to advance the market position of the acquiror.

Shareholders also assume that valuation of the target, structuring of the transaction, and pricing of the bid align to create value to the acquiror. Thus, early high-level analyses need to indicate the combination can produce the level of synergies and other benefits sources that make transaction pursuit worthwhile.

If management of an acquiring utility cannot anticipate an equitable outcome to shareholders across the relevant state regulatory jurisdictions, its board of directors cannot authorize further pursuit of a target, and the transaction will be terminated before ever getting to the regulatory approval stage. This outcome can chill utility management interest in further transaction pursuits, even one in a different jurisdiction.

Deal-breaker risks are borne by shareholders pre-close during the approval application process. Here, the transaction can unravel quickly if all stakeholders are not convinced the proposed transaction has sound strategic logic, effective structuring, appropriate pricing, and little operating risk. These concerns show up early as shareholders provide first approval of the transaction and closely assess potential impacts to them and the company.

Early regulator or intervenor adverse reactions about synergies

levels, costs to achieve, net savings distribution, and sharing timing can set a negative tone early in the process requiring resolution. Finally, the ability to achieve regulatory approval in a reasonable time frame to provide an equitable outcome depends on how the above risks are navigated through the application approval process.

If insurmountable risks to approval exist at this stage, anticipated value to the acquiring and combined utility through available strategic, financial, and operating levers – what might have been – will not be attained. Also, the fully guaranteed benefits to customers from realized synergies will be permanently foregone.

The last shareholder risk category occurs post close when the integration of combining companies is conducted. The risk of not capturing anticipated synergies exists here as original assumptions are either proven or a shortfall occurs.

In the post-close period, the combined company seeks to advance its overall business and build future value and market position that will not be realized for several years. A real risk exists that future regulators not originally involved with original transaction approvals may think differently about matters that come before them, as well as post-close regulatory assumptions that do not come to fruition.

Certainly, customers bear certain risks related to a proposed transaction, though those risks are very different in nature. Shareholders bear the risk that a transaction looks like a good idea, but really is not, as anticipated value sources and financial results are not ultimately available.

Customers, on the other hand, need to count on utility management to ensure commitments and outcomes, such as full synergies are realized, and that the transaction does not turn out to be "a good idea, but couldn't be made to work."

However, the risks customers may bear are not equivalent to those borne by shareholders. First, the commitments agreed to by the combining companies set forth the parameters of regulatory expectations (such as financial conformance) to be met and are used by regulators to ensure adherence and performance.

Second, combining companies have committed to providing specific synergies levels to customers, thus guaranteeing provision. Third, utilities have a strong track record of attaining expected synergies levels, so real concern over performance is ameliorated. Finally, if unexpected events occur that adversely affect rate levels or financial capability, regulators have multiple levers before future rate cases to ensure customers are protected.

An adverse regulatory reaction at any stage of a transaction is undesirable to all stakeholders: shareholders, combining utilities, customers, communities, regulators, and intervenors. The solution is for utilities to clearly demonstrate to regulators the value ascribed to customers is real. But delivering fulsome benefits to customers without an equitable and time-synchronized synergies distribution and costs-to-achieve recovery method is confiscatory.

Crafting the Plan

Given the significance of obtaining an equitable regulatory outcome, particularly as transaction scale and value-at-risk continue to increase, the importance of a well-crafted regulatory plan has never been higher. Unfortunately, the dichotomy in views about what this looks like between utilities, regulators, and intervenors is particularly stark.

The regulatory plan developed by combining utilities needs to rechallenge its historical purpose and move from an obligatory filing component to an instructive, qualitative, and quantitative demonstration of value created and provided only by the transaction. The plan needs to address critical themes and evidentiary dimensions necessary to fully frame the presentation of merger benefit creation and subsequent sharing, particularly the equitable outcome desired from the merger approval proceeding.

A well-constructed regulatory plan is the most critical element of the application approval filing.

Utilities need to clearly assess the current regulatory environment that, while generally supportive of mergers, is less constructive in devising and ensuring equitable results for shareholders. Companies need to step back and define first principles for equitable merger benefit distribution outcomes.

This requires an enhanced framework to guide the presentation of related principles, rationales, facts, impacts, and results related to merger benefits sharing.

Future approval applications need to include a comprehensive and detailed discussion of the multiple dimensions of merger benefits: foundational assumptions, lifecycle risks, nature of benefits and related costs, timing of outflows and inflows, benefits distribution impacts, and overall outcome symmetry, as summarized below:

Shareholder risks: This often overlooked and misconstrued topic relates to the risks assumed by shareholders in financing, enabling, and supporting the merger from idea inception through and beyond ultimate close. The regulatory plan needs to fully discuss the relationship of these risks to end-to-end merger execution and establish a framework for their recognition.

Synergies elements: As a centerpiece of most mergers, reduced O&M and fuel costs are fundamental to addressing a public-interest test, but they are often lightly discussed in approval applications, if at all. The regulatory plan should fully describe the derivation, level, and attainability of synergies, which are a table stake for demonstrating proof of merger value.

Synergies timing: The attainment of synergies takes several years, which is an important dimension of consideration of synergies distribution timing. Merger synergies can only be realized

once the transaction is closed, and they do not go positive until sometime in the second year, which bears full demonstration and discussion in the regulatory plan.

Costs to achieve: Every merger incurs out-of-pocket costs to make the combination happen and bring anticipated benefits to fruition – they are a requirement for transactions and are pivotal to outcomes. While costs to achieve are the reverse of synergies in timing (such as heavily up front vs. ramping up over time), they are not discretionary or avoidable, and cannot simply be ignored.

Synergies distribution: The critical outcome of a merger application approval process is the direction by regulators on how net merger synergies are to be shared between shareholders (the providers) and customers (the beneficiaries). If regulators optimize customer value at the expense of shareholders, then customer benefits from the instant and future transactions will be at risk.

Ongoing value recognition: Approval applications typically address near-term synergies impacts linked to only the next rate case when O&M cost levels would be reconsidered. The regulatory plan needs to propose and justify multi-year mechanisms that recognize the continuing nature of synergies benefits to customers and enable a more equitable and longer benefits distribution to reflect shareholder risks.

> “To achieve a fair and equitable merger outcome, utilities need to emphasize construction of a comprehensive, cogent, and compelling regulatory plan.”
>
> *– Tom Flaherty*

Commitments and conditions: Regulators incorporate discrete commitments (such as low-income support, economic development, new investment, foregone arrearages) and specific conditions (such as dividend restrictions, financing capacity, notice provisions, headquarters staffing). The regulatory plan should acknowledge these items, particularly soft or hard commitments that can add to overall deal value.

Total benefits: While the public-interest test typically focuses on direct customer benefits, broad value sources exist to build traditional benefits (such as new jobs, new facilities, grid modernization) with nontraditional horizon sources (such as accelerated fossil retirements, future transition end-state readiness, net-zero emissions attainment), creating powerful public-interest benefits.

Synergies tracking: Regulatory commission requirements to formally track and report achieved net synergies against expectations for attainment are a common trend in recent transactions. The regulatory plan should propose how synergies and costs-to-achieve are to be efficiently captured through existing mechanisms for regulatory reporting.

With a robust regulatory plan as part of the approval application, utilities can position themselves to increase regulator awareness of transaction risks, benefits, costs, and equity, and increase the potential to achieve an equitable and extended financial outcome from the transaction in the form of continued synergies sharing.

When combining utilities prepare their regulatory plan, the provided information should present a multi-year view of benefits and a robust and compelling delineation of outcomes, including a terminal value calculation to provide an all-in view of shareholder and customer distribution.

Regardless of type, timing or duration, these comprehensive benefits need to be reflected to create a value scorecard for regulators to determine how to apportion benefits between shareholders and customers.

When a multi-dimension, multi-year view of benefits is provided, it is then possible for regulators and all parties to the proceeding to obtain a fully informed perspective of the relationship between risks and apportionment, synergies and costs, and distribution and equity.

Equitable Results

Utilities and their shareholders undertake combinations with the expectation they will be treated fairly in recognizing financial commitments made, and risks taken, from approval application filing through years after the close.

Like being allowed the opportunity to earn the authorized return in a rate case, the corollary for a merger transaction is that utilities will be afforded the opportunity to be compensated for risks assumed over the course of the transaction and the costs incurred to enable benefits to customers to be realized.

Utilities know that a regulatory application approval process does not always follow a standard methodology for how specific outcomes are derived, even if relevant precedents exist. They realize that they bear the burden of proof to provide comprehensive information and specific analyses to justify desired results.

Utilities need to provide a full set of data, rationales, and outcomes that make it easier for regulatory commissions to understand the fairness and financial trade-offs that exist and

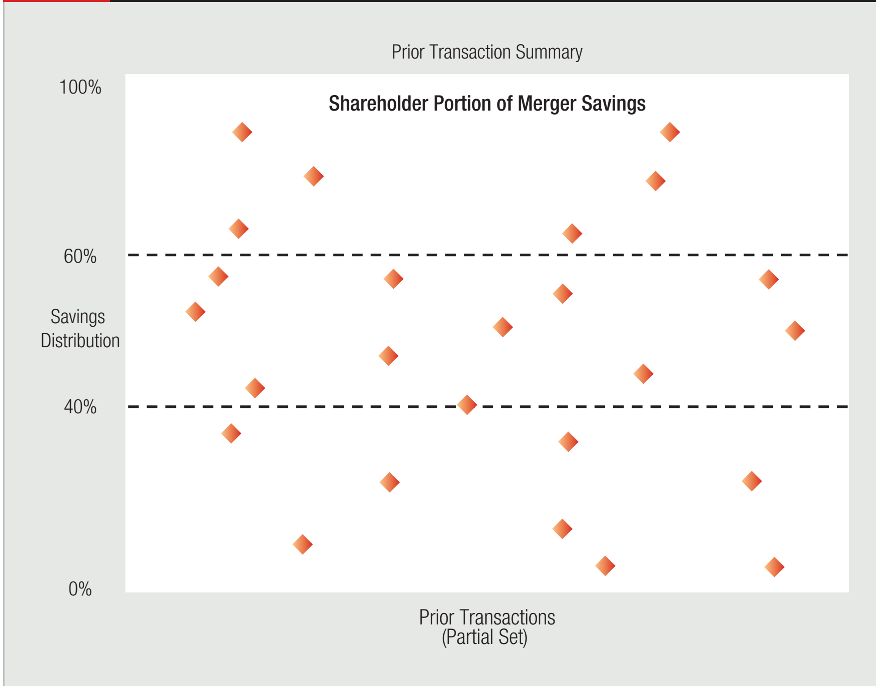
FIG. 3 **STAKEHOLDER VALUE IMPACTS**

Stage	Shareholder impacts	Customer impacts
Pre-Announcement	Price premium (–) Banker fees (–) Target diligence (–)	N/A
Pre-Close	Financing fees (–) Regulatory approval (–) Integration costs (–) Technology conversion (–) Separation costs (–) Shareholder approval (–)	N/A
Post-Close	Customer costs (–) Community costs (–) Balance sheet costs (–) Separation costs (–) Technology conversion (–) Cost recovery (+) Energy transition (+) Infrastructure build (+) Shared savings (+) Multiple expansion/reduction (+/–)	Costs-to-achieve (+/–) Charitable contributions (+) Low-income assistance (+) Economic development (+) Job retention / growth (+) Infrastructure clean-up (+) Infrastructure build (+/–) Arrearages (+) Emissions reduction (+) Shared savings (+)

Note: (+) indicates positive benefit; (–) indicates a negative cost; (+/–) indicates a variable outcome

Source: Flaherty, Thomas J. Roll-Up: The Past, Present, and Future of Utilities Consolidation. EY-Parthenon analysis.

FIG. 4 **HISTORICAL SAVINGS DISTRIBUTION**



Source: Flaherty, Thomas J. Roll-Up: The Past, Present, and Future of Utilities Consolidation

the direct advantages to all stakeholders of achieving equitable benefits sharing.

When the breadth of transaction risks between shareholders and customers is individually and collectively considered, it's clear that a disproportionate level falls to shareholders. Recognition of these risks does not mean shareholders should automatically receive a disproportionate amount of the benefits from the transaction. But it does mean they should be treated fairly in how benefits are shared with customers, which implies an equitable sharing.

See Figure Three.

While regulators do not necessarily need to incent utility combinations to occur, they also do not need to take actions that dis-incent pursuit. Several tenets provide a foundation to frame the sharing of savings between shareholders and customers in a typical merger:

Shareholders bear a range of risks throughout the transaction process that exceed those borne by customers; shareholders are only rewarded for these risks through a fair synergies sharing outcome; costs-to-achieve are a necessary element of achieving a deal and realizing synergies; merger synergies exceed costs-to-achieve to create net synergies; net synergies to customers will generally extend into perpetuity; and absent a formal designation of ongoing net synergies sharing for shareholders, the risks they have already, and will continue to assume, are inadequately recognized or recompensed.

To recompense shareholders for the risks assumed does not suggest that net synergies need to be shared equally, but it is not a bad place to start. An equal fifty/fifty net synergies sharing certainly is fair, given the risks borne by shareholders, recognizes the relationship between merger synergies and costs to achieve, and has the benefit of regulators adopting this approach in numerous prior transactions. This sharing level also signifies a recognition that no synergies would be available if a transaction were not previously funded by shareholders.

See Figure four.

However, other factors can come into consideration. Fuel supply synergies exist in many transactions, and, as a typical hundred

percent pass-through charge, they naturally flow to customers via traditional fuel clauses. Thus, the combination of fuel supply savings and net synergies automatically skew these savings toward customers and create an asymmetrical benefit sharing, unless otherwise recognized and addressed.

Similarly, corporate center synergies may also be allocated to nonregulated businesses that a utility maintains outside the regulated cost of service, thus reducing the level of net synergies available to customers. In this case, net synergies could naturally skew toward shareholders if not reflected.

Under these examples, either shareholder or customer sharing of total net synergies might not be equal (such as sixty/forty to customers) but could still be equitable overall if fifty/fifty sharing of regulated, nonfuel net synergies is maintained. They could also be equitable if total regulated and nonregulated merger net synergies flowed sixty/forty to shareholders if fifty-fifty sharing of regulated net synergies is still maintained for customers.

Absolute sharing can also reflect rate moratoriums that cause a hundred percent of nonfuel net synergies (without an upfront rate credit) to inure to shareholders until the next rate case is filed, typically within two to four years. With this short-term advantage to shareholders, regulators typically fully claim net synergies for customers for all future periods.

But is a fixed, short-term net synergies sharing model equitable for savings distribution when savings realization for customers continues year after year into the future? On the surface, it appears highly inequitable, given the disproportionate level of front-end risks assumed and the gradual ramp-up of merger net savings until steady state in year three.

When costs-to-achieve incurrence can offset available synergies for most of the first three years after close, it becomes continually more asymmetric to customers in succeeding years as synergies escalate and no mechanism exists for shareholders to participate in any ongoing benefits.

The solution is to extend the duration of net synergies sharing for shareholders into future years through redetermination of a traditional short-term symmetric shareholder – customer split of fifty/fifty, to a level more directed toward customers, such as seventy/thirty, over a defined period.

Another approach is to use a return-on-equity band that provides a range-of-return upside to shareholders if the authorized return is exceeded by synergies realization, say fifteen to twenty-five basis points, for a fixed period to recognize prior risks and the availability of net synergies into perpetuity.

A third approach creates a deferred asset for ongoing net synergies with a specific level of annual amortized savings recognition, agreed sharing distribution, and defined period (such as seven years). Under this approach, customers continue to receive annual benefits into perpetuity, while shareholders are provided with the opportunity for additional near-term net synergies capture. Recognizing the typical skew of total net synergies realized by customers compared to those relegated to shareholders would further recompense investors for the risks that were originally incurred and are continually borne.

Adopting a multi-period net synergies sharing framework is best done in the merger application approval process, when all factors can be considered together, rather than in a later rate case, when revisiting merger outcomes is less likely. If other regulatory decisions further disadvantage shareholders and the utility (such as disallowance of out-of-pocket costs to achieve or cost write-offs), then net synergies sharing would further skew toward customers and necessitate additional recognition by regulators to avoid a one-sided, inequitable outcome.

Pursuing an equitable outcome in every merger proceeding should be the ultimate objective of all combining companies, but it is not an easy undertaking; shareholder risks, synergies levels, costs-to-achieve legitimacy, and benefits distribution are all argued from different perspectives. While the goal of an equitable outcome seems relatively straightforward, the variability in philosophies, rationales, policies, and practices creates a complex regulatory environment for utilities to navigate.

To have a real opportunity to achieve a fair and equitable merger outcome, utilities need to emphasize the construction of a comprehensive, cogent, and compelling regulatory plan that sets forth the logic and rationale of risk apportionment, net synergies, and savings sharing sought in the merger application approval order.

A well-constructed regulatory plan is the most critical element of the application approval filing since it enables utilities to demonstrate how the entire range of merger actions and impacts culminate in an equitable overall sharing of merger benefits over the near- and long-term. PUF