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Electric and Gas Utility Mergers and Acquisitions: Structuring Deals, Navigating Regulatory Scrutiny

TUESDAY, MARCH 6, 2018

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

William S. Lamb, Partner, **Baker Botts**, New York

Catherine P. McCarthy, Partner, **Bracewell**, Washington, D.C.

John E. Rooney, Founding Partner, **Rooney Rippie & Ratnaswamy**, Chicago

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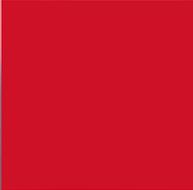
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Deal Structure and Key Contract Terms in Utility Mergers and Acquisitions

Bill Lamb

bill.lamb@bakerbotts.com

March 6, 2018

Overview of Presentation

- What makes utility mergers and acquisitions different?
- Deal structure
- Key provisions in merger and acquisition agreements
- Special provisions in utility merger and acquisition agreements
- Regulatory approval pre-closing covenants
- Other constituencies post-closing covenants
- Closing conditions – no regulatory MAE
- Reverse break-up fees

What Makes Utility Mergers and Acquisitions Different?

- Time required to obtain the necessary regulatory approvals
- Mergers and acquisitions in other industries often can be closed in a matter of several weeks after signing
- Mergers and acquisitions of regulated utilities often are subject to approval by a variety of state and federal regulators, a process that can take many months, sometimes over a year
 - Average time from signing to closing for utility deals over the past few years has been about 10 months
- The time frame and other elements of the regulatory approval process affect
 - Deal structure
 - Contract terms
 - Regulatory approval covenants
 - Closing conditions
 - Reverse break-up fees
 - Post-closing covenants regarding other constituencies

Deal Structure

- Regardless of industry, acquisitions are almost always structured as a merger, tender offer, purchase of equity (shares or units) or purchase of assets
- If target is a public company merger, transaction can be
 - “One-step” – straight merger
 - Requires a vote of shareholders, followed by closing only after all closing conditions have been satisfied.
 - In a transaction with long regulatory approval time, the shareholder vote can be obtained well in advance of closing
 - “Two-step” – tender offer followed by a “back-end” merger
 - In this structure, a majority of the outstanding shares are purchased in a tender offer and then the remaining shares are acquired following a merger vote (the outcome of which is predetermined since the acquirer controls a majority of the shares)
 - When regulatory approvals are not required, or can be obtained quickly, a two-step transaction permits an acquirer to purchase a controlling interest in less time than it would take to obtain shareholder approval in a one-step transaction (1 to 2 months versus 3 to 4 months)

Deal Structure (continued)

- Acquirers want to gain control as quickly as possible so the tender offer can be a better approach in circumstances where all conditions precedent to closing can be satisfied relatively quickly
- However, the one-step structure is preferable in circumstances where it will not be possible to close the tender offer in less time than it is likely to take to obtain the shareholder vote approving a merger
- The reason is the so-called “fiduciary out” present in virtually all public company acquisition agreements
- Fiduciary out permits the Board of Directors of the target company to reconsider the transaction in certain circumstances, generally when the company receives a materially better offer on an unsolicited basis
 - In a one-step transaction, the fiduciary out terminates upon shareholder approval of the transaction
 - In a two-step transaction, the fiduciary out is not terminated until the tender offer closes
- Consequently, if it is likely to take more than three or four months to obtain regulatory approvals, the one-step transaction is preferable

Key Provisions in Merger and Acquisition Agreements

- At a very high level, virtually all merger and acquisition agreements contain sections dealing with the following:
 - Transaction structure
 - Target/Seller representations and warranties
 - Buyer representations and warranties
 - Target pre-closing covenants
 - Buyer pre-closing covenants
 - Post-closing covenants
 - Closing conditions
 - Post-closing indemnification
 - Termination rights and fees

Special Provisions in Utility Merger and Acquisition Agreements

Provisions	Key Elements	Key Elements in Utility Context
Structure	Merger, tender offer, equity or asset purchase	Similar, except that tender offer rarely used
Target/seller reps & warranties	Cover a range of legal, financial and operating matters	Similar to other industries with some variation for unique aspects of utility companies
Buyer reps & warranties	Legal, financial and operating matters relating to buyer	Similar to other industries
Target pre-closing covenants	Restrict interim operations of target; take all necessary actions to satisfy closing conditions; no solicitation of other offers	Similar but must address longer time period between signing and closing
Buyer pre-closing covenants	Take all necessary actions to satisfy closing conditions, including obtaining financing and all regulatory approvals	Similar, but much more robust regulatory approval covenant
Post-closing covenants	Often fairly limited, addressing employee benefits, D&O indemnification	Cover range of issues relating to other constituencies, such as headquarters, employees, charitable contributions
Closing conditions	Reps and warranties true and correct, no injunction, all regulatory approvals and third party consents obtained, no MAE	Similar; MAE carve-outs specifically crafted for utility company, including no "regulatory MAE"
Post-closing indemnification	Heavily negotiated; typically applies only on private-company transactions	Similar
Termination Rights and Fees	Outside date; injunction; no shareholder approval; MAE; breach; failure to obtain regulatory approvals; target can pay fee in the event it exercised fiduciary out	Similar, but reverse break-up fees often tied to failure to obtain regulatory approvals

Pre-Closing Covenants – Regulatory Approval

- Most acquisition agreements contain covenants requiring buyer and seller to use “reasonable best efforts” or some similar standard to obtain all necessary regulatory approvals to close the transaction
- In utility transactions, these covenants are often more robust than in other industries
- Contract terms are very seller-friendly
- Typical agreement specifies that buyer must use reasonable best efforts (and sometimes an even higher standard – “hell or high water”) to obtain all required regulatory approvals
- This obligation includes agreeing to conditions on future operations of the company
- Most agreements specify that the buyer does not have to agree to conditions that would result in a regulatory MAE on the target company or buyer

Closing Conditions – No Regulatory MAE

- Closing of a utility acquisition is subject to receipt of all required regulatory approvals
- Many agreements also specify that the approvals be obtained on terms and conditions that will not impose a “Burdensome Condition” or “Regulatory MAE” on either the target company or the acquirer
- If conditions in regulatory orders would result in a material adverse effect on target or buyer, buyer does not have to close
- Gauges for what constitutes a regulatory MAE vary
 - Can be based on the combined company (usually stock-for-stock mergers)
 - Target company only (with similar gauge for buyer; buyer being deemed to be the same size as the target company)
 - Fractional gauge – i.e., based on a company deemed to be 50% (or even 25%) of the size of the target company

Termination - Reverse Break-Up Fees

- In the event the agreement is terminated under circumstances where the required regulatory approvals have not been obtained, many agreements specify that buyer must pay a “reverse break-up fee” to target
- This incentivizes the buyer to do everything necessary to obtain the approvals
- At one time, RBU fees were roughly the same size as primary break-up fees (the fee payable by a target company in the event it exercises its fiduciary out to enter into an alternative transaction)
 - Primary break-up fees are generally 2% to 4% of transaction equity value
 - Courts have struck down fees in excess of these amounts as coercive
- However, RBU fees are not limited by the same legal constraints as primary break-up fees and they have grown over the past few years
 - RBUs range from 3% to over 5% of transaction equity value
- Also, once limited to public company transactions, RBUs now appear in private company transactions as well

Post-Closing Covenants - Other Constituencies

- Another fixture of utility acquisition agreements is post-closing covenants addressed to shareholders and other constituents
- Common examples include
 - Maintenance of headquarters in current location for some period of years
 - Board split between directors of buyer and target
 - Maintenance of pre-closing levels of community involvement, including charitable giving
 - Allocation of key management positions, including CEO, Chairman and others
 - Advisory boards, including requirements that some members have local affiliation

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ELECTRIC AND GAS UTILITY MERGERS AND ACQUISITIONS:

State Regulatory Scrutiny

March 6, 2018

John E. Rooney



Topics for Discussion

- I. When is State Approval Needed?
- II. Standards for Approval
- III. Information Required With Initial Filing
- IV. Going-In Commitments
- V. Considerations Imposed/Agreed To
- VI. Planning Conditions

I. When is State Approval Needed?

Change in ownership of a utility – statutory examples:

- VA Code §56-888.1: “Control’ means (i) the acquisition of 25 percent or more of the voting stock or (ii) the actual exercise of any substantial influence over the policies and actions of any public utility or telephone company.”
- IL: 220 ILCS 5/7-204(a): “Reorganization’ means any transaction which, regardless of the means by which it is accomplished, results in a change in the ownership of a majority of the voting capital stock of an Illinois public utility; or the ownership or control of any entity which owns or controls a majority of the voting capital stock of a public utility; or by which 2 public utilities merge, or by which a public utility acquires substantially all of the assets of another public utility; provided, however, that "reorganization" as used in this Section shall not include a mortgage or pledge transaction entered into to secure a bona fide borrowing by the party granting the mortgage or making the pledge.”
- Minnesota Stat. §216B.50: “No public utility shall...merge or consolidate with another public utility or transmission company operating in this state, without first being authorized to do so by the commission.”

I. When is State Approval Needed? (Cont'd)

Examples where state PUC approval not needed:

- Illinois

- Unicom/PECO

- Exelon/PEPCO

- Georgia

- Argued in Southern Company/AGL Resources, Inc. transaction

II. Standards for Approval

- Customer protections
 - Safe and adequate service
 - Just and reasonable rates

- Customer benefits
 - Savings/rate reductions
 - Low income programs, improvements
 - Improvements to infrastructure/operations

II. Standards for Approval (Cont'd)

- Affiliate protections
- Employment levels
- Impacts on competition
- Utility's financial stability
 - Ability to raise capital on reasonable terms
 - Maintain reasonable capital structure
- Transaction costs not recoverable

III. Information Required With Initial Filing

- Various states require petitioners to submit substantial information with the initial filing. Examples of required information include:
 - Copies of: agreement, stockholder authorizations, balance sheets, certificates of incorporation
 - Information concerning: identities of new directors and principal stockholders and the number of shares to be held by each, total amount of new capital stock to be issued, benefits to the public and the surviving corporation
 - Proposed changes that will affect the public interest
 - Actual (to-date) and estimated transaction expenses (costs and fees)
 - Forecasted capital requirements for utility (both current and projected) sources of capital/projected range of capital structure

IV. Going-In Commitments

Many transactions identify going-in commitments that the utility and other co-petitioners propose as part of the initial filing.

Examples include:

- Maintain FTE levels
- Civic charitable giving –maintain or increase
- HQ retention in jurisdiction
- Rate related
- Infrastructure investment minimums
- Commission reports/audits

V. Conditions Imposed/Agreed To

- Employment/Unions/Safety
 - Specific FTE minimums
 - Corrosion control
 - Compliance
 - Locating services
 - Transmission integrity management
 - Distribution integrity management
- Finance/Cost of Service
- Quality of Service

V. Conditions Imposed/Agreed To (Cont'd)

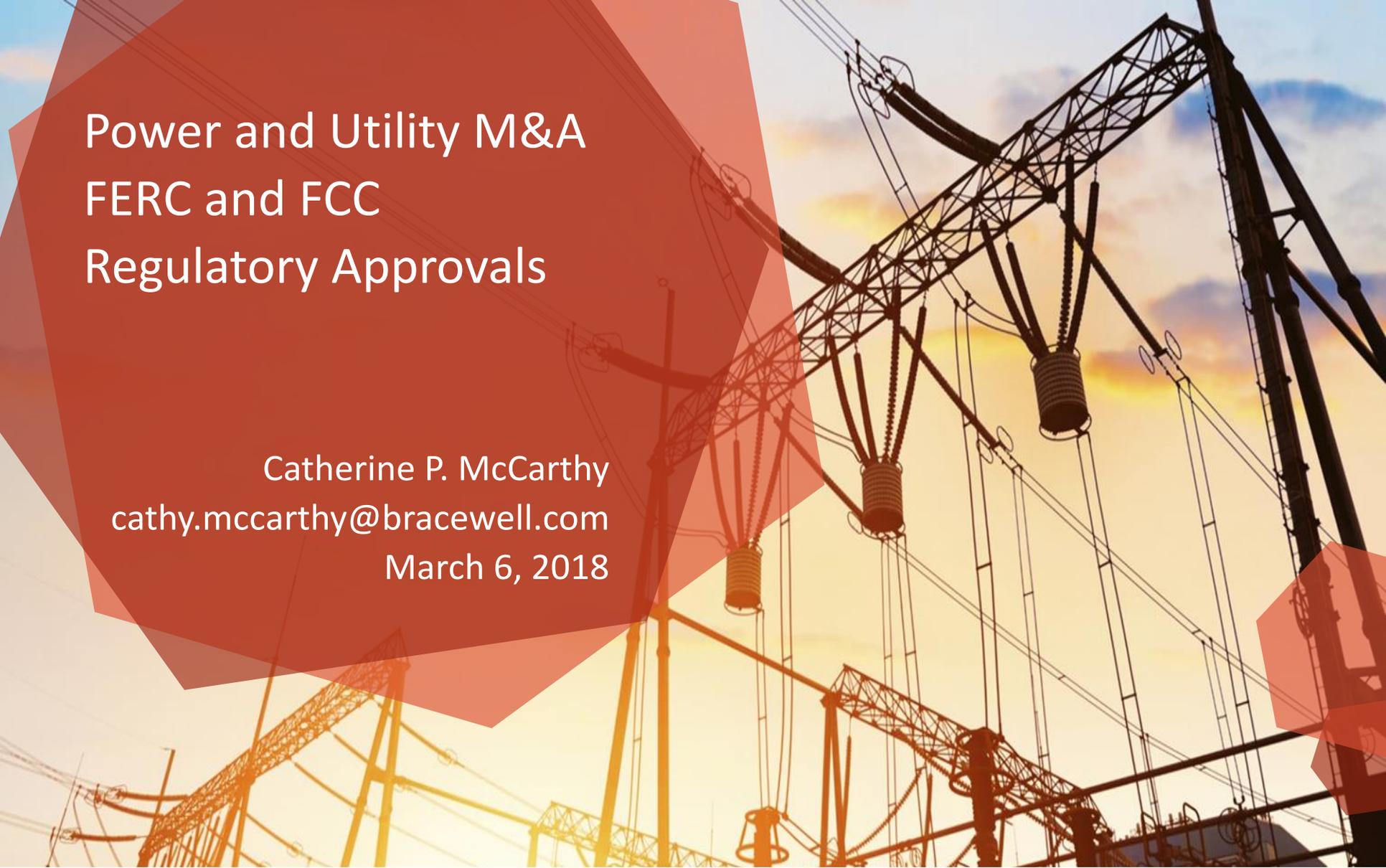
- Civic/Charitable Giving
- Costs/Savings
- Affiliate Related
- Board Membership – Geographic Requirement
 - Annual presentation of CEO to PUC
- Other
 - Affiliate issues (i.e. name change)
 - Competitive suppliers
 - Energy efficiency

VI. Planning Considerations

- Statutory deadline for decision
- Coordinating approval proceedings when seeking approval in multiple jurisdictions/timing of decisions
- HSR Compliance/Data Production
- Synergy Savings/Integration Planning
- Non merger-related demands from Commission Staff and/or intervening parties
 - Competitive supplier issues
 - Consumer advocate issues

Questions?

John E. Rooney
ROONEY RIPPIE & RATNASWAMY LLP
312-447-2800
john.rooney@r3law.com
www.r3law.com



Power and Utility M&A FERC and FCC Regulatory Approvals

Catherine P. McCarthy
cathy.mccarthy@bracewell.com
March 6, 2018

SPECIALIZED DILIGENCE IN POWER UTILITY M&A TRANSACTION

- Confirm Regulatory Status and Whether Prior Federal Energy Regulatory Commission (“FERC”) Authorization Pursuant to Section 203 of Federal Power Act, 16 U.S.C. § 824b, is Required (Definition of Public Utility at 16 U.S.C. § 824(e))
- Examine Complaints Pending Before FERC Related to Target/Counterparty
- Review Generic FERC Proceedings that May Effect Target/Counterparty
 - Counterparty May Participate in Proceedings as part of Trade Association
 - Centralized Markets Proceedings Can be “Big Ticket” Item
 - To the extent issue has been reported to investors, likely “baked into” stock price of publicly traded company but proceedings are multi-party complex civil litigation and should be assessed in diligence in any event

SPECIALIZED DILIGENCE IN POWER UTILITY M&A TRANSACTION (CONT.)

- Analyze FERC and North American Electric Reliability Corporation (“NERC”) Compliance Programs
 - Diligence questions as to FERC and NERC Regulatory Compliance Self-Assessments
 - Assess Content and Frequency of FERC Compliance Training
- Assess FERC Compliance to Confirm General Compliance With Requirements
- Diligence Questions as to Past and/or Ongoing or Anticipated FERC and NERC (or Regional Entity) Audits and Investigations (both formal and informal)
 - Request Information Regarding Resolved FERC or Reliability (NERC or Regional Entity) Audits

SPECIALIZED DILIGENCE IN POWER UTILITY M&A TRANSACTION (CONT.)

- For Utilities Trading Commodities
 - Information regarding any investigation by the Commodity Futures Trading Commission with Respect to the Company and its Affiliates within the last 5 years
- For Owners of Electric Transmission
 - Analysis of Whether Transmission Rates are Subject to Challenge (i.e., are they overearning)
 - Exposure as a Result of New Tax Law

ASSET SALES PRESENT DIFFERENT REGULATORY ISSUES

- FERC Market-Based Rate and Reactive Power Rate Authority May be Required for Generation Asset Sale Transaction
- Coordination Required with NERC for Generation Asset Sales
- ISO Registration and Coordination for Generation Asset Sales
- Generator Interconnection Agreements
- Additional Requirements Could Create Timing Issues

FERC TRANSACTION APPROVAL

- FERC jurisdiction pursuant to Federal Power Act Section 203 applies to transactions by public utilities and transactions by holding companies
- Section 203(a)(1), 16 U.S.C. § 824b(a)(1), requires prior FERC authorization before a *public utility* may:

(A) sell, lease, or otherwise dispose of the whole of its facilities subject to the jurisdiction of the Commission, or any part thereof of a value in excess of \$10,000,000;

(B) merge or consolidate, directly or indirectly, such facilities or any part thereof with those of any other person, by any means whatsoever;

(C) purchase, acquire, or take any security with a value in excess of \$10,000,000 of any other public utility;

(D) purchase, lease, or otherwise acquire an existing generation facility — (i) that has a value in excess of \$10,000,000; and (ii) that is used for interstate wholesale sales over which the Commission has jurisdiction for ratemaking purposes.

FERC TRANSACTION APPROVAL (CONT.)

- Section 203(a)(2), 16 U.S.C. § 824b(a)(2), requires prior FERC authorization before a *holding company* in a holding company system that includes a transmitting utility or an electric utility may:

purchase, acquire, or take any security with a value in excess of \$10,000,000 of, or, by any means whatsoever, directly or indirectly, merge or consolidate with, a transmitting utility, an electric utility company, or a holding company in a holding company system that includes a transmitting utility, or an electric utility company.

FERC TRANSACTION APPROVAL (CONT.)

- FERC Section 203 Merger and Acquisition Authorization Proceeding
 - FERC Standard of Review is Whether Transaction Would Have Adverse Effect on:
 - Wholesale cost-of-service rates (for power sales and/or transmission service),
 - Regulation; and/or
 - Competition
 - FERC Also Considers Whether Proposed Transaction Has the Potential for Cross-Subsidization
- No requirement for Applicants to demonstrate benefits (unlike standard of review at many state commissions)

FERC SECTION 203 ANALYSIS - CHALLENGES

- Competition is typically only substantive issue
 - Critical Path Item frequently the effect of the proposed combination of owned and controlled generation capacity (horizontal market power)
 - FERC Analysis based on and generally consistent with 1992 DOJ/FTC Merger Guidelines
 - » FERC decided not to update analysis when DOJ/FTC updated its analysis
 - Not Identical to DOJ/FTC analysis – DOJ/FTC focuses on prohibition of mergers that substantially lessen competition and FERC's statutory obligation pursuant to Federal Power Act is to ensure that wholesale rates are just and reasonable
 - FERC has seemed concerned about effect of IPP consolidation on long-term capacity markets in ISO-NE and PJM Centralized Markets
 - Vertical market power concerns have been an issue in a handful of transactions (i.e., convergence mergers that could result in adverse effect on competition)

FERC SECTION 203 ANALYSIS - CHALLENGES (CONT.)

- Effect on Rates Analysis May Present Concerns
- FERC 2016 Hold Harmless Policy Statement goes to Applicants' Hold Harmless rate commitments in Section 203 proceedings
 - Although unusual, recent proceedings included opposition focused on transmission rates, wholesale cost-based power rates and retail rates
 - » Concerns about financings effecting cost of capital and those costs being passed through in formula transmission rates
 - » State commission activity at FERC regarding retail rates

FERC SECTION 203 ANALYSIS - CHALLENGES (CONT.)

- Applicants May Offer or FERC May Require Applicant to Offer Proposals to Mitigate Market Power
- FERC Prefers Structural Mitigation to Virtual Mitigation
 - Transmission Investment to Alleviate Congestion Caused by Transmission Constraints
 - Generation Divestiture
- Interim Mitigation

FERC SECTION 203 ANALYSIS - CHALLENGES (CONT.)

- Timing
 - FERC Action Differs According to Type of Transaction, Assets and Companies Involved and Level of Opposition
 - Statute Now Requires FERC Action Within Six Months – But Can be Extended
 - Filing With Term Sheet OK

SELECTED RECENT FERC PROCEEDINGS FOR ELECTRIC M&A TRANSACTIONS

- Great Plains Energy – Westar, 162 FERC ¶ 61,174 (2018)
- Iberdrola USA – United Illuminating, 151 FERC ¶ 62,148 (2015)
- Fortis – ITC Holdings - 156 FERC ¶ 61,219 (2016)
- Hydro One – Avista - 162 FERC ¶ 62,030 (2018)
- AES Generation – Rockland - 162 FERC ¶ 62,095 (2018)
- Dynegy – GDF SUEZ thermal transaction - 157 FERC ¶ 61,237 (2016)
- PSP – GDF SUEZ hydro transaction - 155 FERC ¶ 62,136 (2016)

DON'T FORGET POSSIBLE FEDERAL COMMUNICATIONS COMMISSION PRIOR AUTHORIZATION REQUIREMENT FOR UTILITY M&A DEAL

- Communications Act of 1934, as amended, Requires that Federal Communications Commission Wireless Licensees Obtain Prior Authorization from the FCC For Transfer or Change in Control Over the Licensee
- Section 310(d) of the Communications Act Imposes Broad Mandate on FCC to Approve Any Indirect Disposition of FCC License:

No construction permit or station license, or any rights thereunder, shall be transferred, assigned, or disposed of in any manner, voluntarily or involuntarily, directly or indirectly, or by transfer of control of any corporation holding such permit or license, to any person except upon application to the Commission and upon finding by the Commission that the public interest, convenience, and necessity will be served thereby.

47 U.S.C. § 310(d)

DON'T FORGET POSSIBLE FEDERAL COMMUNICATIONS COMMISSION PRIOR AUTHORIZATION REQUIREMENT FOR UTILITY M&A DEAL (CONT.)

- Utilities Use Wireless Licenses for Intracompany Wireless Handheld Communications Systems, to Implement Automated Meter Reading and for Microwave Pipeline Communications
- FCC Has Expressed Concern About Utility Industry's Failure to Obtain Required Approvals
 - FCC Fined Certain Utility Companies for Failing to Obtain Required Approvals
- Approvals Have 180 Day Shelf-Life but Can be Extended
- FCC Provides Practical “Nuts and Bolts” Guidance:
<https://www.fcc.gov/reports-research/guides/private-wireless-licensees-obligations-under-section-310d-communications-act-1934>

FCC AUTHORIZATION FOR UTILITY M&A (CONT.)

- Transfer Process Relies on FCC's Universal Licensing System
 - FCC Has Streamlined the Process (2004 Initiative) – typically takes less than a month and can take as little as 1-2 days
 - Licenses With Issues May Not be Able to Take Advantage of Streamlined Process and Can Delay Process by 1-3 Months (Good to Start Early)
 - Microwave Build-Out and Notification Issues
 - Failure to Obtain Approval for Past Transactions
 - Improper Registration of FCC Licenses
- Companies Can Take Steps in Advance to Prevent Delay
 - FCC Compliance Plan
 - Review of recent large transactions involving operating companies to ensure proper FCC approval for those transactions obtained
 - Assemble and maintain information about the utility's FCC licenses in a database
 - » Alert operating personnel whenever action is required for license (i.e., when microwave build-out notification needs to be submitted to the FCC)

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