Achieving a Balance between Divestiture and Integration:
Texas Must Avoid Obstacles to Investment in Its Power Sector

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From the perspective of economic development and consumer welfare, there are few more important tasks for government than assisting the marketplace in providing affordable and reliable electric power. In the state of Texas, as we have previously reported, we face particular challenges in addressing a looming shortfall in reserve margin.[1] Fortunately, Texas has been able to attract significant interest from investment sources.[2] While these potential investments in the utility sector have generated understandable interest from policy makers, it is important that they resist the temptation to adopt overly prescriptive interventions that can best be handled by the marketplace.

For example, statistical analysis of the power needs of Texas discloses a clear and present need for additional capital flow to the state. As we recently wrote:

"For decades, Texas has been the nation's fastest-growing large state, adding population and employment at a multiple of the national averages. The state has a current population of 23.5 million and an employment base of 10 million. According to the Texas Workforce Commission, just over 892,000 of these jobs were in the manufacturing sector, accounting for more than 9

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[1] BL Weinstein & TL Clower, Our Energy Future: The Need to Expand and Diversify Texas Power Generation (March 2007) at http://www.unt.edu/cedr/PowerDiversification.pdf.

[2] See, e.g., discussion of potential investments in new generation by TXU, NRG, Exelon, and Amarillo Power, at BL Weinstein, "Fission around, " *Ft. Worth Star-Telegram*, May 4, 2007, at http://www.star-telegram.com/245/story/91040.html.

percent of non-agricultural employment. The state is projected to grow to 40 million by 2030 and add nearly 5 million jobs. Implicit in these projections is an assumption that reliable and adequate supplies of electricity will be available at a reasonable cost. But by the end of the decade, according to the Electric Reliability Council of Texas, electricity demand could well outstrip supply. Indeed, ERCOT projects that Texas will need up to 48,000 megawatts of new power just to keep up with expected demand."[3]

But despite this need for investment, recent debate among Texas policy makers has included significant discussion of mandatory "divestiture" policies. In essence, some believe there must be rigorous mandatory divestiture of operating units occasioned by certain new investments in the sector. Some policy makers are actually seeking a full equity spin-off of these operating units. Such a result would be tantamount to the state of Texas telling equity investors how to structure their companies. While transparent accounting and separation of assets makes good sense, policy makers would do well to remember that artificial barriers to operational coordination within a transaction may create substantial barriers to new investment.

As we discussed in our March 2007 report, Texas must attract investment into the utility sector. If the state adopts a policy that directly interferes with the ability of component electric utility units to coordinate and thereby hedge risks appropriately, one can easily foresee a reluctance of investment capital to come into the state. A recent Standard & Poors analysis of the energy sector cautioned that mandatory concessions and divestitures "could make companies much more cautious about investing the enormous amount of time and money involved in the

[3] Id.

regulatory approval process."[4] Another independent research group, Credit Sights, termed the utility sector "one of the last remaining ones to rationalize, and we don't think tiny fiefdoms of small utilities make sense."[5]

By contrast , the creation of appropriate economies of scale and synergies is important to the well-being of the power sector. As a Merrill Lynch analysis recently argued, economies of scale allow utilities "to negotiate lower prices on fuel equipment. The latter matters because utility companies will spend billions of dollars to upgrade transmission grids and plants over the next several years." [6]

In a more general sense, overzealous divestiture programs can present a general affront to regulatory certainty. Research from the Electric Power Research Institute (EPRI) (2006) found that the "past three decades transformed the electricity industry. A predictable future is now clouded by unprecedented complexity and uncertainty." [7] But requiring air-tight compartments in the name of divestiture makes a bad situation worse. The study found that "the continuation of regulatory uncertainty" contributes "to the drying up of investment in this highly capital-intensive industry, as reflected in declining generation capacity margins..."[8] In short, successful

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[4] Standard & Poor's Equity Research, "Supercharged Risks for Electric Utilities," *Business Week*, September 25, 2006, http://www.businessweek.com/investor/content/sep2006/pi20060925_417317.htm (citing S&P analysis from Justin McCann).

[5] Michael Brush, "Utilities get the urge to merge," MSN Money, March 8, 2006, at http://moneycentral.msn.com/content/P145683.asp (citing CreditSights analysis).

[6] Id. (citing Merrill Lynch analysis).

[7] Hung-po Chao, "Global electricity transformation: The critical need for integrated market design and risk management research," *Energy* 31 (2006) at 923 (analysis performed by Electric Power Research Institute).

[8] Id. at 928.

utility policy "depends on finding an appropriate balance between government regulation and market competition."[9]

European observers have also grappled with the restructuring of their utility sector and have come to similar conclusions regarding the need to balance regulatory certainty with the desire to effect comprehensive divestiture of constituent units. An analysis of the policies in the European Union concluded that regulators "must promote a climate of investment and regulatory certainty" and cautioned against requiring divestiture that "would negatively affect the utilities' cost of capital."[10]

While comparisons between electric utilities and telecommunications should be undertaken cautiously, experience with divestiture mandates in the telecommunications sector also offers a cautionary tale. Only two days after the Federal Communications Commission announced its intentions to divest local telephone networks, SBC, BellSouth, Verizon and Qwest lost over $12 billion in market capitalization, with wireless and equipment companies also posting millions in losses. Offsetting gains were modest.[11]

The problem of air-tight compartmentalization of divested units in the utility sector does not leave policy makers without solutions that protect consumer welfare. It is always possible to

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[9] Id. at 933.

[10] David Niles, "Asset unbundling," *Energy Business Review Online*, March 19, 2007, at http://www.energy-business-review.com/article_feature.asp?guid=07C5BFA6-816B-4342-9B56-C3C89B70CC72.

[11] Written Submission of the Competitive Enterprise Institute, Regarding the Telecom & High Tech Manufacturing Sector, before the Department of Commerce, International Trade Division, Manufacturing Roundtables Proceeding (July 18, 2003), available at http://www.cei.org/pdf/3634.pdf.

work with potential investors to ensure that operating units are factually separated, with unique identities and transparent accounting. But to prohibit coordination of investments across functional lines only creates an obstacle to needed capital flow. EPRI compares the insistence on full divestiture to "a doctor prescribing a standard treatment before making a diagnosis" because the underlying assumption is that one solution applies to all circumstances.[12]

Decades of research on market design and risk management suggests that allowing for appropriate separation and transparency – designed to reflect the actual circumstances of the market and the need for certainty – is less risky than full divestiture for attracting the needed investment to avoid electricity shortfalls. As EPRI concluded, market problems "so far resulted from over-reliance" on divestiture strategies. The "better approach" is "to develop a customized solution between vertical integration and full unbundling."[13] Moving to full divestiture would essentially transform the state into a partner in every transaction, thereby creating great uncertainty inconsistent with the attraction of new investment capital.

[12] Chao at 935.
[13] Id. at 938.