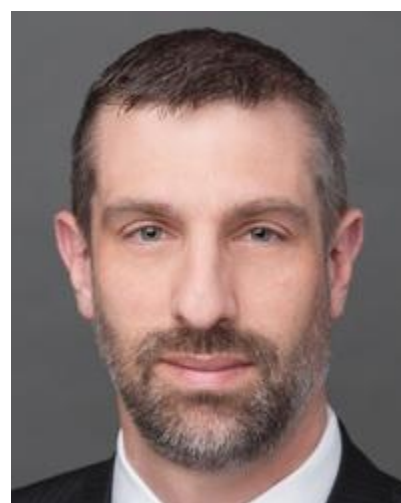


## '2ab' FERC Merger Analysis Easy As 1, 2, 3

*Law360, New York (December 01, 2014, 2:07 PM ET) --*

Recently, the Federal Energy Regulatory Commission has made some subtle but important changes in the way it analyzes applications for changes of control in generation assets. This evolution of FERC's competitive analysis screen, or "Appendix A" or Delivered Price Test analysis, may have major impacts on applicants seeking approval for sales or purchases of such assets.

In processing several recent Section 203 applications for asset transactions, and in several recent orders, FERC has required some applicants to increase mitigation measures to account for not just screen failures in "basecase" analyses, as it traditionally has done, but also to mitigate for screen failures in sensitivity analyses. In addition, in some cases FERC has called for a more complex approach to modeling power flows, which will add complexity, time and expense to such analyses.



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But the recent changes are not all bad. FERC has also allowed the use of a simplified analysis in some cases as an alternative to the traditional competitive analysis screen, which has both reduced costs and sped up approval time considerably.

### **The Competitive Analysis Screen**

Section 203 of the Federal Power Act requires FERC approval before a change in direct or upstream control of FERC jurisdictional electric generating or transmission assets may occur. FERC's regulations in turn require the submission of a competitive analysis screen when there is more than a de minimis overlap in geographic markets where the merging entities own generating assets.

The competitive analysis screen is an analytical tool that looks at the change in concentration in the market for electric generation output as measured by the Herfindahl-Hirschman Index (HHI), a market concentration measure commonly used by economists. FERC requires that this analysis be conducted under a variety of season, load and price scenarios, and for anywhere from one to many geographic markets (depending on the particular facts of the case).

When a transaction results in an increase in a market's HHI by more than a certain amount (which varies based on the overall level of market concentration) it is known as a "screen failure." While not all screen

failures require mitigation, most do. If applicants do not propose market power mitigation measures in response to legitimate screen failures, such as selling assets to reduce market concentration, FERC approval could be delayed significantly or the application could be denied. Applicants thus generally propose to mitigate screen failures in their applications in order to avoid such problems.

### **Mitigating Screen Failures in Sensitivity Analyses**

It is important to understand the recent changes to FERC's approach to mitigation. As part of a competitive analysis screen, applicants submit a "basecase" analysis based on observed market prices. FERC regulations also require applicants to include some sensitivity analyses based on increased or decreased market prices. Historically, the sensitivity analyses had no clear impact on whether an application was approved or what mitigation was proposed or required. When entities proposed mitigation, it was usually only to address screen failures in the "basecase" analysis. Indeed, until recently there was no indication that mitigation was needed to eliminate any screen failures in the sensitivity analyses. Rather, sensitivity analyses were historically submitted as a diagnostic tool, enabling FERC to see that the market prices in the basecase were reasonable.

This changed with the Duke-Progress merger. In that case, applicants initially submitted to FERC a competitive analysis screen showing some limited screen failures in both the basecase and sensitivity analyses but argued that these screen failures did not result in competitive concerns. FERC responded by requiring the mitigation of screen failures both in the "basecase" analysis and in the two sensitivity analyses. On Oct. 29, 2014, FERC stood by its approach in an order on rehearing.

While FERC did not expressly proclaim a new policy in Duke-Progress, the writing on the wall is clear. Duke-Progress was a larger than average transaction involving significant amounts of generating capacity. Still, the approach taken by FERC in that case strongly suggests that applicants now must understand and appreciate the clear risk of submitting an application that does not mitigate all nonsystematic screen failures, including those in price-sensitivity analyses. In some instances, price sensitivities may require only a small amount of additional mitigation, if any. In others, mitigating sensitivity analyses could require significantly more megawatts of mitigation and/or mitigation in more seasons or periods of time (i.e., peak/off-peak), as appears to have been the case in Duke-Progress.

### **Modeling Intermarket Power Flows in Competitive Analysis Screens**

In recent years, applicants have conducted competitive analysis screens under a modeling assumption that aggregated into a "super-market" all markets (usually Balancing Authority Areas, or BAAs) directly interconnected with the market being analyzed (i.e., first-tier markets). This approach simplifies the reality that BAAs are interconnected to each other through a complicated network of transmission facilities, each with their own limits. Previously, this simplified and commonsense approach appeared to satisfy FERC and made the inherently complicated competitive analysis screen a little less so.

FERC however appears to have changed course recently. In two relatively small proceedings, one involving Nevada Power Company (Docket No. EC14-84) and the other Tucson Electric Power Company and its affiliate UNS Electric Inc. (Docket No. EC14-88), FERC sought from applicants competitive analysis screens that reflect the BAA-to-BAA limits, rather than merely limits from the aggregated "super-market."

Following these orders, the first-tier "super-market" continues to be the foundation of the competitive analysis screen. But rather than just model the transfers between this "super-market" and the market

being studied based on an aggregate transmission limit (a single “Simultaneous Import Limit” or SIL for the entire “super-market”), FERC appears also to be looking for analysis that takes into consideration the transfer limits between each BAA that makes up the “super-market” and the BAA being studied.

This change in modeling assumptions results in a far more complicated analysis, adding time and expense to the process, as well as to the volume of data that both the applicant and FERC must review. In the Tucson Electric proceeding, this change resulted in the need to model not just one transfer limit (the SIL) but also the five individual limits with its first-tier BAAs and, arguably, the four limits between those first-tier BAAs, resulting in additional costs and complexity.

These cases were not the first time that applicants submitted competitive analysis screens with a more refined modeling methodology than the simple “super-market” approach. Indeed, applicants in Duke-Progress followed such an approach voluntarily. However, the Nevada Power and Tucson Electric cases appear to represent the first time that FERC has called for such an approach. Whether this approach produces more meaningful analyses remains to be seen.

### **Use of the Simplified '2ab' Analysis**

But not all news out of FERC is bad for applicants who need to submit competitive analysis screens. Instead, applicants are increasingly being permitted to use a simplified approach to analyzing the competitive impacts of a transaction through what is colloquially referred to as a “2ab” analysis.

As noted above, FERC’s regulations call for a competitive analysis screen if there is more than a de minimis overlap in geographic markets where the merging entities or assets conduct business. FERC has not clearly defined what quantity of megawatts or market shares qualify as “de minimis,” but the rule of thumb historically used by many FERC practitioners is that a post-transaction market share of less than 3 percent is likely to be recognized by FERC as de minimis.

A proposed transaction is viewed as passing the competitive analysis screen (for a given market, season, set of load data and price) if the post-transaction HHI is: (1) less than 1,000 points, (2) from 1,000 to 1,799 points but the increase is 100 points or less or (3) 1,800 points or more but the increase is 50 points or less. Thus, regardless of the overall market concentration, a proposed transaction will pass the screen if the HHI increase is 50 points or less.

The “2ab” analysis looks at whether a proposed transaction will increase market concentration by 50 points or less, by looking simply at the market shares of the merging entities. The increase in the HHI resulting from a merger is two times the product of multiplying the market shares of the respective entities. Accordingly, a merger of two market participants who combined have a market share of 10 percent or less will, by mathematical certainty, not increase the HHI by more than 50 points.

A transaction resulting in a combined market share of 10 percent would not fall within the historical application of the de minimis threshold. Yet, the “2ab” analysis shows that the transaction would pass the competitive analysis screen thresholds under any level of post-transaction market concentration, as the HHI increase is only 50 points.

The “2ab” analysis does not require the complicated, time consuming and costly process of calculating the season/load/price-specific market shares of all participants in an effort to arrive at a marketwide HHI. As a result, the “2ab” approach saves countless hours as compared to the competitive analysis screen.

Perhaps even more importantly, the less data submitted to FERC means less time required for FERC to review and analyze the data, which generally means a faster approval process. While a “2ab” analysis is not feasible for every application, it is associated with a faster approval process and is well worth considering.

In fiscal year 2014, there were at least four Section 203 applications containing “2ab” analyses submitted to FERC. These four applications were approved in about one-half the time required for the applications containing only traditional competitive analysis screens. Of course, an apples-to-apples comparison of applications is not possible as each transaction is unique, but those four cases suggest procedural advantages to applications that use the “2ab” analysis.

## Conclusion

These seemingly subtle changes to FERC’s approach to applications for changes of control of generating assets will have significant impacts on how analyses are conducted. On the one hand, FERC appears now to want applicants to mitigate any screen failures of price sensitivity analyses and to follow a more complex approach to modeling intermarket power flows in competitive analysis screens. On the other hand, FERC has opened the door to a greater application of the de minimis exception to the need to complete competitive analysis screens, which may allow some applicants to avoid the need for an unnecessary and complicated analysis and speed their approval process.

By many accounts, 2015 should be a very active year for potential transactions subject to FERC review. As such, we recommend that potential deals be reviewed at the earliest possible stage with these changes in mind. In the long run, early analysis reduces costs and enables management to focus on deals that can be done without significant mitigation.

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***DISCLOSURE: William Scherman was counsel in several of the transactions discussed in this article and Jeffrey Jakubiak was counsel to Tucson Electric Power Company in that company’s FERC proceeding noted in the article.***

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