Can Mergers Distort Competition?
Anticompetitive Conduct and Unearned Advantage

Scott Hempling
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Mergers change market structures; market structures affect seller conduct. To protect competition on the merits, we must ask this question: Will a proposed merger weaken market structures, allowing the merged company to act anticompetitively or exploit unearned advantages?

Anticompetitive conduct

Aggressive, pro-competitive conduct becomes unlawful, anticompetitive conduct when the seller acts to weaken competition rather than win the competition. Pro-competitive behavior yields competition on the merits. Anticompetitive behavior undermines competition on the merits. The incentive and opportunity to behave anticompetitively is especially strong when the merged company, directly or through affiliates, sells services in two distinct markets: one where it has a state-protected monopoly and one where it does not. It can exploit its market power in the former to undermine competition in the latter.

Anticompetitive conduct can take at least four forms. *Refusing to deal* means denying competitors access to key inputs controlled by the merged company. A prominent example is transmission—essential for generation competition but not economically or practically duplicable by the generation competitors. If the merged company controls an upstream input and also competes with its wholesale customer in a downstream market, the company might also *price squeeze*—overcharge the wholesale customer for the upstream input, then underprice the customer in the downstream market. With *tying*, the merged company forces a customer who needs the company's monopoly product (e.g., transmission access) to also buy the company's competitive product (e.g. generation), thereby cutting out all generation competitors. Then there is *cross-subsidizing*: the merged company underprices its competitive product by overcharging for its monopoly product, thus abusing customers and competitors—a real two-fer.

Unearned advantage

Anticompetitive conduct means winning by cheating. Unearned advantage is different. Today, electricity products are diversifying. Some, like distribution and transmission, are monopoly services; others, like solar, wind, storage and microgrids, are potentially competitive services. Incumbent utilities want to provide both types. In these potentially competitive markets, incumbent utilities have advantages that their non-utility competitors lack. If unearned through merit, these advantages distort competition.

A utility incumbent's unearned advantage comes from multiple sources. Customer inertia, a natural phenomenon, is made more powerful by the incumbent's *branding*—its name emblazoned on hundreds of trucks, thousands of uniforms and each of its buildings. The incumbent also enjoys the *government's imprimatur*, a benefit attributable not to the company's merits but to the state government's own inertia—because regulators almost never seek better performers, even when the utility bungles multibillion construction projects (e.g., SCE&G's V.C. Summer nuclear plant, Mississippi Power's Kemper project), causes eight deaths by botching pipeline maintenance (PG&E), or gets convicted of felonies and obstruction of justice (PG&E again). People are awed by electricity; when they transfer that awe to the utility, they create what behavioral psychologists call the *halo effect*. Then there are the utility's internal characteristics. It has *economies of scale*—not because it performs well but because it provides a service having an inherently declining cost function, and because it has received government-protected service territory large enough to exploit that cost function. This government-protected incumbent also has *service territory knowledge* and *technical expertise*, all funded by ratepayers rather than acquired through risk-taking. And thanks to statutory and constitutional law mandating rates that compensate the utility fairly, the utility has *predictable earnings*, allowing it raise capital inexpensively.

Now add to these status-related factors the utility's own actions. It sends monthly bills with *announcements, advice* and *offers* designed to build and cement loyalty; the incremental cost is near zero. The utility also can use its ratepayer-funded knowledge to *tie up large, attractive customers in long-term contracts*—ensuring stable revenues that allow it to finance equipment at low cost.

None of these features arises from the utility's merits; they all come from its government-protected status. Unearned advantage is a way to win without being the best. In markets as in life, unearned advantage undermines competition on the merits.

Electricity monopoly mergers: entrenching the incumbents' power

A ***horizontal merger*** reduces the number of competitors. Among them might be mavericks—companies that shake up market structure by cutting prices and offering new services. Whereas mavericks lie within the market, potential competitors hover outside the market. Their entry threat disciplines the incumbents. Mergers that eliminate mavericks or potential competitors weaken the competitive pressures that benefit consumers.

Some merger applicants aim for first-mover status in new product markets. Early birds deserve their worms; but if the merged company gets its worm not through merit but through its government-favored position, competition will not be effective.

Mergers of adjacent utilities raise distinct problems, because they eliminate head-to-head competition, wholesale generation competition, yardstick competition and franchise competition. Adjacent utilities need not have been competing head-to-head for their merger to weaken competition. First, if the merging companies both own generation, they compete with each other in wholesale generation markets. Second, states that don't yet authorize retail

competition could do so in the future. Two adjacent companies, given their sizes, name recognition, employee experience and regional knowledge, would be the other's most formidable competitor. Third, even when adjacent utilities don't compete with each other door-to-door, they compete to attract and retain industrial and commercial customers. And comparison competition can lead to franchise competition—what one court called an "elimination bout" for the exclusive franchise. A realistic threat of losing one's government-protected monopoly will pressure a utility to control costs and improve service. Mergers diminish that pressure.

A ***vertical merger*** joins an upstream company with a downstream company—two companies whose products are links in the same chain of production: a generation-owning utility buying a transmission-owning or distribution-owning company in the same geographic market. Unlike a horizontal merger, a vertical merger does not by itself eliminate a competitor. But vertical mergers can damage competition: in downstream markets, by foreclosing competitors' access to inputs; in upstream markets, by foreclosing competitors' access to customers; and in both upstream and downstream markets, by enabling the merged company to collude with competitors.

What about innovation? Competitive companies compete not only on cost, price, output and quality, but also on innovation. Mergers can affect innovation. A firm facing strong competition when selling its current products needs to develop new products. Mergers can weaken this pressure. But also possible is the opposite: A merged company facing less competition can spend more money on innovation.

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Competition is effective when market structure causes sellers to compete on the merits: no market dominance, no anticompetitive conduct and no unearned advantage. Mergers affect both market structure and seller conduct. Horizontal mergers reduce the number of competitors; vertical mergers can give the merged company control of inputs needed by competitors. Protecting competition on the merits means screening mergers for both problems, while establishing conditions that prevent anticompetitive conduct and eliminate unearned advantages.