Contests For Control: Who Should Make The Rules?

Scott Hempling
April 2014

To acquire a utility is to win a contest. Who runs that contest—who makes the rules and who chooses the winner—determines whether the public interest is served or disserved.

A privately-owned cafeteria in a government agency building has the exclusive right to sell meals on site, subject to the agency's minimum requirements for food choice, price range and sanitation. Consider two ways to change the cafeteria's ownership. The cafeteria could run a contest, choosing the bidder who offers the incumbent the highest price. Or the agency could run the contest, choosing the bidder who offers the customers the best food at the lowest prices.

In utility acquisitions, regulators don't run the contests; the incumbent utilities do. Like the contest run by the cafeteria, the incumbent utility chooses the buyer who can satisfy the regulator's minimum conditions while paying the highest price for the utility's stock. What seals the deal is the "fairness opinion": a third party's declaration that the price is "fair"—to the acquirer and acquiree, not to consumers or the public. The deal is then approved by the regulator if it satisfies the regulator's minimum conditions. But in the dozens of utility mergers since the 1980s, those minimum conditions have never included "best food at lowest prices."

Non-Competitive Markets, Non-Competitive Results

In utility mergers, then, the incumbent is the initiator while the regulator is the reactor. This role differential would pose no problem if the merger took place within a competitive market, because in a competitive market the competitors' strivings necessarily promote the public interest. The acquiree would still demand the highest possible price—a premium over its current market value—but the acquirer's bid will be disciplined by competitive pressures. The acquirer will pay a premium no greater than what it can recover through the prices it charges for service in the post-acquisition market. If those prices are disciplined by real competition, the acquirer will pay a premium no greater than the new economic value that the coupling will create. In a competitive market, that new economic value is necessarily a public interest benefit. So if the market is competitive, an acquisition contest run by the acquiree can produce a public interest result. An acquirer striving to satisfy the acquiree will simultaneously satisfy the public.

But utility mergers don't take place in perfectly competitive markets. Because the acquiree is a retail monopoly, competitive pressures must be replicated by the regulator. But regulation has its own imperfections. In the merger context, the key imperfection is asymmetry of information. See, e.g., DoJ/FTC Merger Guidelines §10 ("[Merger] efficiencies are difficult to verify and quantify, in part because much of the information relating to efficiencies is uniquely in the possession of the merging firms."). The merging companies know things that regulators don't know, like ways to cut costs and gain market power in existing or developing markets. With this knowledge advantage, the acquirer can afford to pay a premium because

when the merged company cuts costs or exercises market power, it can keep the gains. Without the knowledge advantage, the merged company wouldn't pay the premium because it couldn't keep the gains; the knowledgeable regulator would discover the gains and transfer them to the customers, like a perfectly competitive market would. Because utility mergers take place in imperfect markets, the contest for control, if run by the incumbent and reacted to by the regulator, does not serve the public.

This is the world in which, over two short decades, 200 electric utilities have become 50; a world undisciplined by fully competitive markets or fully informed regulation. Each transaction has featured a premium, based on the assumption that the merged entity could, without detection, cut costs savings or gain market power. Market imperfection allows private aim to diverge from public interest, with the private aim prevailing due to gaps in regulatory knowledge. With regulators unable to do their job—inducing performance that is economically efficient—they have authorized consolidation that is economically inefficient.

Solution: Merger Competition Run by the Regulator

As long as retail utility service has monopoly features, market imperfection is a given. But the regulatory gap is not a given. Like the agency that runs the cafeteria competition, a commission can run the acquisition competition. When the commission runs the competition, the winner is not the one offering the largest premium to the incumbent's shareholders; it is the one offering the best service to consumers.

Do regulators have the legal authority to run the merger contests? They might and they should. Most utility acquisition statutes apply a "public interest" test. If a transaction emerges from an imperfect market, and if the regulator lacks essential information—i.e., if the incumbent has run the contest—the transaction cannot pass the test. So we get rejection of a suboptimal acquisition, but we don't get approval of the optimal acquisition. Is there a way for the regulator to run the contest, like the agency seeking a new cafeteria owner?

Under the typical state utility franchise law, the commission would have to declare the incumbent's service inadequate, then issue a request for proposals for replacements. It's happened many times in the water context; when small companies fail, the regulators find replacements. And Hawaii, Maine, Oregon and Vermont have done it in the energy efficiency context, relieving incumbent utilities of that role, issuing RFPs and selecting the best bidder. But no one has done it in the retail electricity service monopoly context. Even the few states that have acted assertively against merger proposals sought no alternatives to those transactions. California (1991) and Montana (2006) explicitly rejected proposed mergers. Maryland (1997) and New Jersey (2006) imposed conditions that caused the applicants to drop their deals. Once the proposals disappeared, these agencies expressed no interest in alternative couplings. In short, decisions to transfer the monopoly privilege have been initiated only by the companies that have enjoyed the privilege, not by the regulators who have granted the privilege.

* * *

The dozens of merger approvals already granted cannot readily be undone. But we can correct the resulting inefficiencies, by subjecting existing franchises to commission-hosted competitions so that customers get the best service at the best prices. If commissions don't have this authority, they should get it. We should not expect legislatures to recognize this gap on their own. The responsibility for raising the right questions, and getting the right answers, lies with the commissions.