# "Darwin Economics": How Does It Affect Merger Decisions?

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April 2013

*[P]eople are not attentive to costs and benefits in the manner required by traditional theories of rational consumer behavior. For example, people are generally attentive even to small costs and benefits that are certain to affect them immediately, but they tend to give short shrift to even large costs and benefits that either are uncertain or occur with significant delay.*

— Robert Frank, *The Darwin Economy: Liberty, Competition, and the Common Good* (2011)

Last month's essay described a disparity in determination, between merger promoters and merger regulators. Promoters of utility mergers have an affirmative goal: Preserve and increase shareholder value, by maintaining or growing market share, increasing profits, and/or limiting competition. They also have affirmative strategies: acquiring strategic assets, leveraging a monopoly position in one market to gain entry and control in other markets, and/or channeling ratepayer-funded resources to new competitive businesses. Merger regulators are less affirmative than passive. Their approach is Hippocratic: "Do no harm"—don't raise rates, don't reduce competition and don't degrade service. To reduce this disparity, I recommended that regulators articulate and enforce their own affirmative policies, in four areas: business activities, ownership relationships, consumer risks and protective tools.

But doing so is difficult. As Cornell Professor Robert Frank writes, "people are generally attentive even to small costs and benefits that are certain to affect them immediately, but they tend to give short shrift to even large costs and benefits that either are uncertain or occur with significant delay." How does this tendency affect merger decisions? Do regulators over-emphasize the short-term rate freezes and small-time charitable contributions, while under-emphasizing the long-term consolidation in market structure?

Having participated in or studied most of the 50-odd utility merger decisions since the mid-1980s, I see four questions deserving attention: (1) Do we under-estimate the risk of bigness? (2) Do we over-estimate the benefits of short-term contributions? (3) Do we over-associate benefits to the merging companies with benefits to the public? (4) Do we under-estimate the difficulties of off-ramps? This essay addresses the first question. Next month's will work on the other three.

## The Pressure toward "Bigger": Does it Undermine Industry Performance?

As the 25-year merger trend continues, a new argument is emerging: "We have to get bigger because others are getting bigger." These utility statements cite no evidence of efficiencies from economies of scale or scope, or of innovation begotten by bigness. The emphasis is not the public's interest in performance but rather the utility's interest in relative size.

The trend is fed by the financial community. A CFO in a mid-size utility (one that has avoided mergers) told me that for smaller utilities, the market for their stock is less liquid. Low liquidity means that fewer institutional investors will buy the stock, because it is harder to unload it. Further, "larger companies ... have more buying power in the marketplace, layering on an added impediment to mid-cap utilities seeking to raise capital." (This view is admittedly anecdotal. Regulators should gather comprehensive evidence on the question.)

The stock-buyer's bias toward bigness is based on maximizing profit, not serving the public. Those two goals need not conflict, especially when regulatory policy aligns compensation with performance. But when utility merger strategy is driven not by performance but by relative size, there is potential for conflict. Three examples:

1. As the holding company's acquisitions grow, the attention paid by the CEO and Board to each utility shrinks. This can happen even within a single utility. A utility's transmission vice president, charged with maintaining reliability, told me that "Corporate" rejects his pleas for upgrade-and-repair funds because transmission is only 15% of the company's whole.

2. As the corporate family invests in riskier ventures, the investor portrait changes. Conservative investors, who buy-and-hold patiently, expecting only stable dividends and modest share value growth, lose a reliable, predictable place to put their money. In come risk-takers, pressuring the CEO and Board for large gain. Further, bond rating agencies can no longer give consistently stable ratings, because the family's financial health is no longer based on predictable variables like operational performance, regulatory treatment and cost structure.

3. Utility staff with professional ambitions find that the path to advancement is not in the traditional utility trades but in "corporate strategy." Essential craftspeople—those who make things work—face more job risk because failures in the unrelated businesses can cause the utility to reduce or defer operations, maintenance and modernization.

## The Animal Analogy: Gazelles and Elks

The tension between (a) a single company's drive for relative size and (b) an industry's overall performance has an analogy in the animal kingdom. Robert Frank compares the gazelle to the bull elk. An individual gazelle's advantage relative to its peers advances the interest of the gazelle community. Here's how: The faster gazelles can outrun their predators; the slower gazelles get eaten, their DNA departing the species. The faster gazelles then procreate, allowing the species to survive. The species gets speedier. Contrast the bull elk, whose "outsized antlers ... function as weaponry not against external predators but in the competition among bulls for access to females. In these battles, it's relative antler size that matters....Although each mutation along this path enhanced individual reproductive fitness, ... [l]arge antlers compromise mobility in densely wooded areas, ... making bulls more likely to be killed and eaten by wolves." For bull elks, relative advantage among individuals undermines the species as a whole.

Elk vs. elk is mirrored in state vs. state. If the benefits of relative size accrue to the utility's home state, but the detriments of bigness affect multi-state regions (and eventually the nation), each state will tend to favor its home utility's strategy. This tendency produces conflict between relative advantage and public interest. We get state vs. nation, and state vs. state. The solution here is an alert, active national policy on utility mergers, one that not merely prevents short-term tangible harm but that also defines harm as the loss of future benefits. No such policy exists.

## What about Economies of Scale?

Those arguing for bigness sometimes assert economies of scale, but these are arguments without evidence. That evidence, if and when it is ever collected and analyzed, is likely to vary with the context—with products, geography and technology. Economies of scale for constructing or operating nuclear plants or transmission facilities are different from economies of scale for constructing or operating distributed generation, micro-grids and energy efficiency programs. Whether bigger is better cannot be determined through generalities.

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"Bigger is better" means advantage in relative size. In the merger context, that advantage accrues only to the merging parties, not necessarily to the industry as a whole. If utilities are gazelles, then the trend makes the entire utility industry more efficient. But if utilities are bull elks, the trend helps individual utilities in the short term, but in the long term makes the industry more remote, less consumer-responsive, more likely to pose a problem of too-big-to-fail. Absent a national policy that guides mergers toward industry-wide efficiency, each state decision will tend to support the utility-specific strategies aimed at relative size, without regard for the national interest. The risks of this approach will occupy the next several essays.