Distributed Resources and Distribution Mergers: Are They On A Collision Course?

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To make electricity consumption more cost-effective and less carbon-dependent, states are seeking to stimulate new products and services in the distribution space. Successful stimulation requires effective competition. So Maine and New York are exploring whether to appoint as "smart grid coordinator" (Maine) and as "distribution system platform provider" (New York) an entity independent of the incumbent utility.

But there is a countertrend. Thirty years of utility mergers have consolidated dozens of local distribution companies into a much smaller number of multistate, holding company-controlled systems. When these mergers involve adjacent entities, they remove each merging partner's most formidable potential rival in the new distribution services markets. The latest example is the proposed coupling of Exelon and PHI Holdings, which would eliminate competition between Baltimore Gas & Electric and Potomac Electric.

Thirty Years, Dozens of Mergers, No Studies

Welcome to the most under-studied question in electricity merger policy. For 30 years, regulatory decisions have focused on preventing mergers from creating or enhancing market power over bulk generation and transmission services. No decision has considered a merger's effects on the nascent markets in distributed energy resources. Only two analogues come to mind. The FCC Staff's epic critique of the withdrawn AT&T and T-Mobile merger (2011) cited T-Mobile's "disruptive" innovations in retail products and pricing as a reason to keep the companies separate. And the California Commission's rejection of the Southern California Edison-San Diego Gas & Electric merger (1991) cited those companies' "across-the-fence" rivalry: The "loss of SDG&E as a regulatory comparison is an adverse unmitigable impact of the proposed merger," diminishing the Commission's "ability to regulate the merged utility effectively."[1] In the dozens of other merger decisions, nearly all approvals, no other systematic assessment of distribution-level competition appears.

Preserving head-to-head rivalry applies not only to potentially competitive services, but the new monopoly services as well. Last month's essay, "Incumbency vs. Diversity, Monopoly vs. Merits: Who Should Provide the New Distribution Platforms?" argued for finding the best providers, not defaulting to the incumbent. But any merger proposal points the opposite way; its purpose is to acquire and maintain control, not to acquire and then cede control. (Why else would the acquirer pay hundreds of millions of dollars in acquisition premium?)

Everyone has heard the refrain, "Regulation replicates the forces of competition." In merger cases, that refrain is forgotten. The acquirer gains control of new territory not by proving it is the best performer, but by offering to the acquiree's shareholders the highest price, then offering regulators the minimum benefits necessary to gain approval: temporary rate refunds or

freezes, minor contributions to local charities, commitments to renewable energy (funded by ratepayers); and noncommittal, non-provable platitudes about "synergies" and "best practices." The gain paid to the acquiree's shareholders being worth many times the value of these offerings, the selection process does not "replicate the forces of competition," if by competition we mean competition for the benefit of the customers.

Regulatory Silence: Not a Credible Option

Given these opposing purposes—finding the best provider vs. maintaining incumbent control—a commission must preserve its ability to structure future distribution services markets. It can preserve that ability by conditioning any merger approval as follows: "This approval does not grant the post-merger entity any right (a) to continue owning and controlling the poles-and-wires business, (b) to become the provider of any new monopoly platform services, or (c) to compete in any of the new distributed services markets."

This three-part condition aligns the merging companies' expectations with regulatory realities. A merger is a purchase of control. If future control is uncertain, the transaction's value declines. That fact is not cause for the commission to forego the condition. The value tail does not wag the regulatory dog; it is not the commission's job to protect merger bettors from their competitive risks. But those bettors' expectations are cause to make the condition clear, before the merger is approved. Pre-merger clarity helps everyone: the merging companies' shareholders, who are exchanging value based on their expectation that the merged company will maintain its historic control; the prospective entrants into the distribution space, who may be investing in products designed to reduce that control; and retail consumers, who want to know what services they will be able to buy, and from whom.

So if the commission wishes to preserve its options, it has a decision to make. There are three possible approaches:

1. ***The commission establishes the recommended condition.*** If the commission adopts the condition—making clear that the incumbent has no permanent lock on the future distribution roles—one of two things will occur: (1) The companies will merge—maybe after renegotiating the price—knowing their risks because the commission has been forthright; or (2) the companies will drop the deal, thereby making explicit what had been implicit—that the main purpose of the transaction was not "synergies" but control, that the mere possibility of facing competition-on-the merits was a deal-breaker. The commission's alertness will have exposed the inconsistency between merger premise and public interest, saving everyone money and heartache. The commission can then proceed, like Maine and New York, to assess alternative market structures for distributed energy resources, undistracted by a merger transaction.

2. ***The commission explicitly rejects the recommended condition.*** If some party recommends the condition and the commission rejects it, the logical inference is that the merged entity will continue to control poles and wires, provide the platform services, and be allowed to compete (perhaps through a commonly controlled affiliate) in the markets whose essential infrastructure the utility controls. Unless that continued control is guaranteed by statute,[2] the

commission could someday change its mind. But having rejected the condition, such change-of-mind would be unlikely. Its rejection of the condition would imply that it sees the status quo as satisfactory. That implication would signal to prospective entrants that their competitive prospects are dim. Thus discouraged, they would depart, leaving the service territory dependent on the incumbent. That dependence would cause the commission to continue supporting the incumbent, which support would discourage future prospective entrants, etc.—and so the circle closes, tightly. Competition on the merits loses.

3. ***The commission decides not to decide.*** A "no decision" decision can be made by silence or words. Either path is a problem. Silence could be viewed by the merger applicants as continuing the status quo—the incumbent's continued control, indefinitely. Thus comfortable with the transaction price, they would consummate their merger. Legally speaking, commission silence signals non-commitment. But the practicalities suggest otherwise. Suppose the commission, post-merger, were to announce a competition for one or more distribution roles. The merged company's stock value would drop, because the prospect of competition contradicts the stock market's pre-merger expectation. As explained above, that value loss is not the commission's legal concern, because shareholders made their bets voluntarily. And the merged company's loss is not a societal loss, because it is matched by the value gained by whoever wins the competition. But the regulatory tendency will be to protect the utility, because it is natural to care more about losses incurred by the incumbent we know, than about opportunities denied to the competitors we don't know. Silence undermines competition on the merits.

The "no decision" decision can also be explicit, as in "These questions about distribution control are interesting but we don't need to decide them now." If the merging companies bet the transaction price on continued control, then as discussed above we do need to decide these questions now—at least make clear that there will be a decision by a specified date. Otherwise we leave everyone in limbo. Consumers won't know which new services will be available from whom, when. The merging companies won't know the value of their transaction; that uncertainty will increase their cost of capital, and therefore their customers' rates. (Not all business uncertainty is ratepayers' responsibility; but uncertainty caused by regulatory indecisiveness is.) And newcomers will hesitate to enter the market, because unlike the utility, they have no captive customers to serve while waiting for commission decisions.

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To achieve cost-effective consumption, we need cost-effective supply. Cost-effective supply necessarily includes distributed energy resources, because they empower consumers to manage both their consumption and their supply. And for distributed energy resources to be cost-effective, they must be subjected to distribution-level competition. But helping consumers control their own supply does not come naturally to companies that historically have controlled their customers' supply. And distribution-level competition is unlikely to be welcomed by companies that historically have been protected from competition.

Mergers of distribution monopolies—especially of adjacent companies poised to become each other's worst competitive nightmare—head in the opposite direction. Commissions have

approved dozens of these transactions, paying no attention to their effects on distribution-level competition. Today, the potential for distributed energy resources, provided competitively and cost-effectively, makes such study vital.

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[1] *SCEcorp, Southern California Edison Co.* and *San Diego Gas & Electric Co.*, Decision No. 91-05-028, 1991 Cal. PUC LEXIS 253, at *236-37 & n.68, *238, *262.

[2] See, e.g., South Dakota Codified Laws § 49-34A-42 ("Each electric utility has the exclusive right to provide electric service at retail at each and every location where it is serving a customer as of March 21, 1975, and to each and every present and future customer in its assigned service area.").