Inconsistent With the Public Interest: FERC's Three Decades of Deference to Electricity Consolidation

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Since the mid-1980s, mergers and acquisitions approved by the Federal Energy Regulatory Commission have cut the number of independent retail electric utilities by more than half. These transactions have taken every possible form: horizontal, vertical, convergence, and conglomerate; operationally integrated and remote; domestic and international; publicly traded and going-private; debt-financed and stock-for-stock.

Accompanying this consolidation has been complication. The conventional pre-1980s utility—local, pure play, conservatively financed—is being replaced by multistate and multinational holding company systems: corporate structures housing multiple, and sometimes conflicting, business ventures—structures that owe their financeability and viability to their utility affiliates' monthly cash flow.

Under Section 203 of the Federal Power Act, the FERC must find these consolidating and complicating transactions "consistent with the public interest." Despite multiple policy statements, rules, and 70-plus transaction approvals, the FERC has never defined a "public interest" in terms of the industry's performance. Though the 1996 Merger Policy Statement states a purpose of "encouraging greater wholesale competition," that purpose rarely appears in the FERC's actual merger orders. These orders require only "no harm," and no harm only to pre-merger competition—regardless of whether that pre-merger competition is effective or ineffective. Effective competition exists when a market's structure, and its sellers' conduct, pressure all rivals to perform at their best. By requiring only "no harm," and by applying that standard only to pre-merger competition, the FERC has invited and approved transactions whose contributions to performance are necessarily suboptimal. For 30 years, the Commission's merger decisions have disconnected the "public interest" from performance.

That disconnection has produced, and continues to produce, consolidated asset ownership and complicated business structures. Today's electricity industry resembles nothing any prior FERC intended, because no prior FERC ever stated what it intended—not only in terms of industry performance, but also in terms of the key influences on performance, such as the appropriate number of utility systems in a region, the appropriate mix of businesses and business structures within those systems, the types of owners and the financing they use, and those owners' strategies for subsequent expansion. The main influence on the FERC's merger decisions—the main force determining these industry features—is not any public interest vision, but rather the merger applicants' strategic aims.

The Commission's deference to applicants' strategies is logical, and lawful, when the relevant markets giving birth to these transactions are effectively competitive markets. But when mergers involve retail monopolies, the relevant markets are not effectively competitive. Deference to transactions undisciplined by effective competition cannot be consistent with the public interest.

This absence of a public interest vision, and the resulting deference to private interest transactions, are the big-picture errors. They lead to five main policy errors. The FERC (1) looks only at wholesale competition, ignoring retail competition; (2) views each merger in isolation from the others, ignoring their cumulative effects; (3) ignores the relationship of purchase price to real transaction value, thereby approving transactions whose benefit-cost relationship is suboptimal; (4) allows the transacting parties to allocate nearly all their transaction's value to themselves, disregarding the contributions to that value made by the target's ratepayers; and (5) assumes without inquiry that regulators will be capable and willing to handle the post-consummation complexity.

Supporters of the FERC's merger policy might make two main arguments. First, the Commission's near-universal merger approvals have produced no obvious performance backslide. Second, no studies exist to test whether today's consolidated industry performs less efficiently than had the FERC done things differently. But neither factor proves the policy correct. The mere absence of backslide is the wrong standard to apply to a multi-trillion-dollar, infrastructural industry on which lives depend; the absence of useful studies is reason to conduct them, not to continue a policy unquestioned.

The Commission should re-examine its policy's premises: that "no harm" is the correct standard; that the market structure to which no harm should apply is the pre-merger market structure regardless of its competitive defects; and that the strategies that drive merger proposals are necessarily disciplined by forces aligned with the public interest. That re-examination should take the form of a notice of inquiry, led by a task force with expertise and hierarchical prominence comparable to the Commission's offices on reliability and enforcement. Fact-gathering and analysis, instead of continuous approvals, will help us ensure that future mergers are, as section 203 requires, consistent with the public interest.