Merger Posture: Don't Defer, Lead

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Merging companies seek market control, competitive advantage and "diversified regulatory risk." Merger planners seek stock price increases and cash payouts for target shareholders, golden parachutes for departing executives, and finders' fees for the brokers. As explained in the preceding two essays ("The Dangers of Merger Deference: Parts I and II"), these pecuniary goals do not deserve deference. Effective regulators avoid deference by establishing a vision, then using competition to achieve it.

Establish the Vision: Business Activities, Corporate Structure and Market Structure

Mergers affect markets and, through markets, consumers. How mergers affect markets and consumers depends on (1) the merged entity's business activities, (2) the corporate structure through which it carries out those business activities, and (3) the structure of the markets that host those activities. To assess a merger, the effective regulator first establishes a vision for each of those dimensions. The reason for vision is to eliminate tension: between the utility's public service obligation and the corporate family's business priorities.

Business activities: The no-tension solution is a stand-alone utility serving a single territory, unaffiliated with any other business. From this seed, complexity, and possibly tension, can grow along two main dimensions: geographic (merging with utilities serving other areas, whether nearby or remote); and type-of-business (merging with companies that sell services, either utility or non-utility, to third parties or to the utility itself). The effective regulator allows only those mergers whose additions to complexity are compensated by benefits to the public.

Corporate structure: A utility's stock can be owned (a) directly by ultimate shareholders (e.g., individuals, mutual funds and pension funds); (b) by a holding company (which might own other businesses, utility-related or not utility-related, nearby or remote); or (c) by a holding company that is owned in turn by any of the above holding companies. Alternatively, the utility could itself be the top-level holding company, owning in turn one or more of the above-listed types of companies. These ownership relationships affect (a) who controls or influences the utility's decisions and (b) to what ends that control or influence is exercised.

Corporate structure reflects and affects financial structure—the mix of equity and debt, who holds that equity and debt, and the holders' business goals. These financial factors affect the utility's decisions. Two simple examples: (a) If the utility's holding company pays for acquisitions with debt, this "leveraging" can pressure the utility to divert cash flow from operations to debt repayment. (b) When a non-utility affiliate fails, investors view the holding company as more risky, raising its finance costs; the utility affiliate's equity (which comes from

the holding company) then becomes more expensive. The effective regulator prevents these results by limiting risk-causing activities.

Market structure: A merger changes market structure—the number and types of market participants, the products they sell, their market shares and the assets they control. As Alfred Kahn has written (*The Economics of Regulation* Vol. II at p. 282 (1988)):

> *The preponderant case for the mergers is that they will improve efficiency. The preponderant case against them is their possible impairment of competition, for two reasons: first, the merging companies are typically actual or potential competitors in some parts of their business, and, second, they may be enabled by joining together to deny outside firms a fair opportunity to compete.*

A merger can make the market more or less competitive, generating increases or decreases in efficiency, innovation and customer service. Effective regulators set rules that invite the right kinds of mergers. They have goals for efficiency, innovation and customer service, and know what market structures will most likely achieve those goals. These are the components of vision: the vision helps the regulator distinguish mergers that help from mergers that harm.

Achieve the Vision: Using Competition to Find the Best Players

Faced with a merger, the effective regulator asks this question: "Among all feasible options, which one produces the most improvement at the lowest cost?" The other theoretically feasible options include (a) pressing the incumbent utility to improve without merging; (b) finding alternative merger partners whose combination with the incumbent will produce improvement; or (c) finding one or more alternative utilities that can perform better than the incumbent.

Merger applicants want a lower bar. To win approvals, they change the question: from "Is this the most cost-effective transaction?" to "Will the proposed merger improve—or at least not harm—the status quo?" The typical merger proceeding then assists this frame-shifting by failing to examine alternatives. The standard too easily becomes "any improvement is sufficient improvement"—a standard that invites mediocrity. The effective regulator avoids mediocrity by instead inviting alternatives. She creates a continuous competition for the right to serve the public. Whereas "any improvement on the status" relies on subjectivity (the standard is the incumbent's performance), "comparison-through-competition" ensures objectivity (the standard is the best performer's performance).

Think about it this way: Approving one merger precludes other mergers, just as buying one car precludes buying other cars. You don't buy the car that runs better than your existing car; you buy the car that best meets your full set of criteria—cost, reliability, comfort, looks. Yet commissions regularly ignore this simple practice, approving mergers because they improve (or do not harm) the status quo. Whether merger-produced improvements come at a reasonable cost

can be determined only by comparison to an objective case, one consisting of the best options among all feasible alternatives.

Comparison-through-competition, with the regulator doing the comparing, turns the merger market on its head. In the typical merger process, prospective acquirers bid to buy the utility. The competition is run by the utility, who (all else equal) selects the acquirer offering the highest price. The successful acquirer, then needs to recoup that price through cost-cutting, service-cutting or price-raising, none of which actions necessarily helps the customer. Acquirer interest conflicts with customer interest. But when the competition is run by the commission, the acquirers bid to serve the consumers. The winner is the one who offers the lowest possible price and the highest possible quality. Now the acquirer's interest coincides with the public interest. (Caution: For this approach to work, the commission must have the legal authority to order mergers and/or replace the incumbent. (See my essay “Competition for the Monopoly: Why So Rare?” and my legal treatise Regulating Public Utility Performance: The Law of Market Structure, Pricing and Jurisdiction at Chapter 2.A.3. (1st ed.)))

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In the merger context, establishing a public interest vision means defining the desired business activities, corporate structure and market structure. To make that vision reality, effective regulators don't wait for pecuniarily-oriented transactions, a passenger in the merger market's airplane, adding minor conditions tailored to preserve the transaction while “getting something” for the public. Effective regulators have goals—economic efficiency, innovation, customer service—then invite players to compete to serve those goals. If the winner is a merger, the merger is approved. Regulatory objectivity, not incumbent opportunity, is the aim.