Merger Proceedings II: Do Commissions Make Themselves Marginal?

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August 2013

In this year's merger series, my essay “Merger Strategy: Make Regulators Marginal” described how merger applicants move commissions to the margins. They pour concrete early, distract with “benefits,” and create deadline pressure. My essay “Merger Proceedings I: Do Commissions Make Themselves Marginal?” identified some ways that some commissions help marginalize themselves. Regulatory silence invites self-interest proposals, their hearing procedures induce passivity, and their habit of “yes-or-no” bipolarity constricts their creativity. The July essay broke from this merger series to address rate “incentives” (see essay “Utility Rate Proposals: Are We Aligning Compensation with Performance?”). This month's essay now describes three more ways that regulators self-marginalize.

Treating Current Facts as Permanent Facts

Merger applications describe what the commission will see on merger day: one company where two had been, smoothly combining its predecessors' best practices. This carefully painted picture fills the commission's eye-space. But a merged company is not a static company. It is more than what the application portrays—it is that, plus all the motivations, plans, strategies and tactics that simmer within any acquisition-oriented enterprise. A proposed merger is a trajectory. Its next moves are undisclosed by the applicants and therefore unknown to the commission. To approve this black box without addressing its contents leaves the public interest at risk; it makes consumers passengers in the merged company's airplane.

Humans tend to treat the unknown as unimportant; events of indeterminate probability are viewed as low probability. With mergers, the specifics may be unknown, but the categories of concern are the classic ones: cross-country acquisitions, financed by increasing debt of decreasing quality; internal corporate conflicts over resources; utility cash reserves dividended into non-utility ventures; employees trained on the utility ratepayer's dime, then shifted to non-utility affiliates. These situations are likely to arise when a utility's leaders and owners have plans beyond leading and owning a utility. It happened in the 1930s, it happened in the 1980s, and it will happen again. We know the categories, but we don't know the specifics.

Citing this lack of specifics, merger applicants call these concerns “speculative,” a label that the self-marginalizing commissions then use to justify inaction. But the concerns are not speculative; they are factual. Here are four facts: (1) The Commission cannot predict the merged company’s future acquisitions. (2) The specifics emerge, only after the chips have fallen, too late for regulatory action. (3) The future out-of-state acquisitions will be outside the commission's jurisdiction and control. (4) The acquired businesses can have purposes in tension with, or in conflict with, the original utility's service obligations. To dismiss these four facts is to assume that the merged company's unknown future, its discretion to engage in unlimited

business activities outside the state and unrelated to its original franchise obligation, will leave its customers unaffected. That is the real speculation.

Inviting "Settlements" that Box the Commission In

Merger applicants hunt for the sweet spot: the concessions that remove intervenor opposition at minimum cost to the transaction's promoters. But no single party has a public interest vision for corporate structure or market structure. Each, instead, seeks something for itself: more renewable energy, no layoffs, jobs from new headquarters construction, 3-year rate freeze, investment in broadband, new energy efficiency programs.

So the applicants make promises. Some are literally illusory, like solemnly stated commitments to comply with "lawful" commission orders. Others are blatantly unlawful, like promises to give contract preference to in-state businesses. (Permissible as a private commitment—as a commission condition it becomes regulation that discriminates against neighboring states' businesses, in violation of the Constitution's Commerce Clause.) While some concessions do come from the utility's pocket (Exelon wrote a $100 check to every BG&E customer), most "offers" are activities whose costs are reimbursed by ratepayers. Some even become profit opportunities and first-mover advantages for the utility, like its commitments to construct new transmission or to install (and control the data from) new "smart meters."

Marginalizing is assisted by timing. Merger applicants often seek to settle before hearing, before opponents have the commission's ear. Some applicants try for deals even before the intervenors have filed their testimony or completed their fact-gathering. If settlement discussions occurred only after the hearing, the commissioners could influence outcomes by stating their preferences during the hearing. (At one pre-hearing conference, the FERC administrative law judge walked in and said: "I've read the pre-filed testimony and made 40 pages of notes. On the 15 issues presented, here's where I'm leaning." Settlement happened fast—on his public interest terms.)

By accommodating (and even inviting) these private interest "settlements," a commission moves public interest to the margins. The concession-loaded transaction becomes the "bottom line," the "must have." The transaction-as-settled is unstoppable, because regardless of its public interest effects, no one opposes it. Any conditions then added by the commission must be scaled to save the deal, not to screen it out. The transaction shapes the commission's order rather than the other way around.

In my essay "Regulatory 'Settlements': When Do Private Agreements Serve the Public Interest?" I argued "[s]ettlements are appropriate when they help a commission carry out its public interest obligations. Favorable conditions include: (1) The settlement subject demands technical proficiency, (2) the parties' proficiency exceeds the commission's, and (3) the parties' private interests are aligned with the long-term public interest." A merger doesn't qualify.

Looking Inwards, Not Outwards

Commissions looking for in-state benefits risk overlooking multi-state costs. This diminishes their influence over the industry. Consider the applicants' common claim that the merger will “position us competitively” (the “us” referring to the merging companies). “Position us relative to what?” If the merger elevates the applicants' market position, it necessarily de-elevates someone else's position. In unregulated markets without a dominant player, this elbowing out of another can strengthen competition by keeping others sharp. But in our business, where the utility has a monopoly over a retail market, “competitive positioning” implies an advantage in some new market, a government-assisted leg up on less blessed, non-utility competitors. Asking the regulator to assist “competitive positioning” boils down to “What's good for us is good for our state.”

And it may be good for the state, if the commission thinks only of the short-term benefits offered—the 3-year rate cut, the headquarters building, and the like. But when each state acts similarly, the result is a version of Garret Hardin's Tragedy of the Commons” (see essay, “Interconnection Animus: Do Regulatory Procedures Create a “Tragedy of The Commons”?”). Each state, in return for tangible short-term benefits, has approved a transaction whose market-concentrating effect leads to long-term loss. Like Hardin's herdsman, each state acts rationally, perceiving the value of the internal positives as exceeding its share of the external negatives. But the calculation is wrong. The commons—for Hardin, the pasture; for the regulators, long-term market competitiveness—is damaged. Looking inwards, not outwards, shrinks the regulatory influence.

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“Moving regulators to the margins” is a utility strategy that need not succeed. A commission's counterstrategy is, of course, to place its priorities at the center—well before a merger is proposed. I'll address that idea next month.