Mergers: Are the Promoters Ahead of the Regulators?

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Section 203 of the Federal Power Act requires certain mergers and acquisitions to be "consistent with the public interest." Since its 1996 *Merger Policy Statement*, FERC has applied this standard by assessing a merger's effect on competition, rates, and the effectiveness of regulation. Does its approach need updating?

FERC's competition analysis includes a concentration calculation with roots in the 1992 *Merger Guidelines* published by the U.S. Department of Justice and Federal Trade Commission. (Quick tutorial: Those guidelines are based on the Herfindahl-Hirschman Index. The HHI is the "sum of the squares of the shares" of the market participant, with shares measured in percents. A monopoly market has the maximum HHI of 10,000, which is 100 squared; a market with five equal-share (20%) sellers has an HHI of 2000.)

In 2010, the DoJ-FTC announced several changes to its 1992 *Guidelines*. Some of these changes relaxed concentration standards, in two ways. The new policy raises each of the concentration thresholds for the categories of "unconcentrated," "moderately concentrated," and "highly concentrated" markets. The policy also increases the amount of merger-caused concentration that would trigger official concern in each of those market categories. For example, under the 1992 *Guidelines*, a market whose HHI was 1800 or above was labeled "highly concentrated." If a merger increased a highly concentrated market's HHI by 100 points, it was deemed anticompetitive. The 2010 guidelines changed these numbers to 2500 and 200, respectively.

In February 2012, FERC announced it would not revise its own horizontal market power screen to reflect the DoJ-FTC's new guidelines. FERC found that the "more stringent [1992] thresholds are appropriate, especially given the distinctive characteristics of electricity markets."

FERC's concern with "concentration" is helpful, but its three-part approach (competition, rates, and regulation) needs updating. In 2005, Congress repealed the Public Utility Holding Company Act of 1935. For seventy years, the Act's "single integrated public utility system" mandate required electric and gas utilities to stick to their knitting—essential utility service to local customers. The Act had three key tools:

> *Section 10(b)(1) required the SEC to veto any utility holding company acquisition that "will tend towards ... concentration of control of public-utility companies, of a kind or to an extent detrimental to the public interest or the interest of investors, or consumers."*
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> *Section 10(c)(2) allowed only those acquisitions that "tended towards the economic and efficient development of an integrated public-utility system."*

Section 7(d) prohibited issues of equity or debt that, among other things, involved an "improper risk" or were "detrimental to the public interest or the interest of investors or consumers."

With PUHCA repealed, federal law now allows unlimited geographic dispersing of utilities and assets, without regard for operational efficiencies; unlimited mixing of utility and non-utility businesses; unlimited corporate layering; and unlimited debt-leveraging of utility and nonutility subsidiaries. No longer is corporate structure aligned with public service obligation. Our retirees' "safe investment" has changed its character.

Yet the Federal Power Act's standard, "consistent with the public interest," remains unchanged. That standard both allows and obligates FERC to reshape its merger review to catch up with industry-side strategies that place pecuniary ambition ahead of public interest. Consider two points. First, FERC limits its "concentration" calculations to the transmission, generation, and "ancillary service" markets. But utility mergers affect many other markets, including retail competition, energy services (such as combined gas-electric products), and now the fragile markets for storage, distributed generation, demand response, and the many components of smart grid. Some utility holding companies have explicit strategies to win over those markets. Using their government-protected monopoly status as credibility-enhancers, they win Wall Street praise for "strategic vision"; but that vision is a private, pecuniary urge not necessarily aligned with the public interest. (Example: A utility needs low generation prices for its customers, but its generation affiliate wants high prices for its shareholders. Which interest is the holding company CEO likely to favor?) The public interest is less needful of the same century-long players extending their reach, and more desirous of seeing numerous new players test their wares with consumers learning to use energy-related technology. Despite the breadth of its statutory authority, for over two decades FERC has kept its analysis conventional.

The second point is that "competition" is not the only value at risk in a merger. FERC does look at "effect on rates." A strategic merger can affect rates, negatively, for decades if it precludes other couplings with better benefit-cost ratios. Instead of insisting on long-term efficiencies, FERC is satisfied with three-year rate freezes—leaving intervenors with no leverage to address the long-term needs of dependent consumers. As for a merger's "effect on regulation," FERC has never addressed the strain on regulatory resources, especially within state commissions (who are part of the "public interest" FERC is obligated to protect), caused when a multistate holding company pursues plans that make utility service a minority activity within its corporate family.

Those who call these concerns speculative are the ones doing the speculating. They speculate that (a) shrinking the CEO's attention to the utility's public service obligation, (b) mixing public service obligations with unregulated business activities that conflict with those obligations, and (c) magnifying the complexity of the regulatory task without increasing the scope and skill of regulatory staff, all create no risk of customer harm.

It comes down to the "vision thing." Some regulators wake each day able to articulate an appropriate industry structure, able to describe an optimal, or least tolerable, mix of players small and large, horizontally and vertically related, diversified and focused. Others come to work

without a vision for the industries whose performance they are sworn to improve (the purpose of regulation is performance, correct?). The former are poised to guide the players' legitimate self-interests toward the public interest; the latter become passengers in someone else's airplane.

To align corporate form with public service obligations, we need to simplify corporate structures. That means allowing geographic dispersion and utility-nonutility mixtures when they produce measurable, enforceable economies of scale and scope, respectively. It means limiting the layers of and interactions among corporate affiliates to those necessary to achieve efficiencies for consumers. The world economy has plenty of places for investors to take risks. They don't need to bring our utilities along with them.

FERC's merger policy reflects none of this. What to do? Given the gap between public interest concern and federal regulatory attention, the job falls to the states. The task is to develop clear-eyed tests that distinguish efficient from inefficient transactions, that place less emphasis on transitory rate cuts and more emphasis on long-term accountability—to regulators, consumers, investors, and the public.