Merging parties divert franchise value from the customers who created it

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I dedicate this month's essay to the memory of one of my dearest colleagues. Steve Dottheim was for decades the Deputy General Counsel of the Missouri Public Service Commission. His devotion to the cause of effective regulation ("the most fun you can have with your clothes on," he'd say) was matched only by his devotion to his two nieces, his sister, his brother-in-law, the St. Louis Cardinals and the Negro Baseball Leagues. A mentor to many, one of the most decent, hard-working, ethical and self-deprecating people I ever knew, Steve had a sharp sense of humor, most often directed at himself. He had no patience for fools or their hearing-room baloney. He was a tough, accurate judge of people. I am but one of many whom Steve made a better lawyer and a better person. Rest in peace, Steve.

My essay "Suboptimal Couplings Cause Economic Waste" explained how electric utility mergers waste economic resources. They also divert value. In most mergers, the acquirer pays to the target shareholders a control premium—the excess of purchase price over stock market price. Routinely, regulators let the shareholders keep the entire premium, allocating none of it to customers. This lopsidedness ignores the real source of value in utility mergers—the customers.

The value of control: Leveraging market position

When an individual investor buys stock, she buys only a sliver of the company. Her sliver gives her no influence, so she pays only the market price. In a utility merger, the acquirer buys more than stock; it also buys control. Control allows the acquirer to increase earnings in ways ordinary investors cannot: by controlling decisions on business priorities, infrastructure spending and rate increase requests; decisions on whether to accommodate or obstruct competitors; decisions on all ways to use the acquired utility as a platform for buying new businesses or entering new markets.

Sources of the control premium's value: Unconnected to the target utility's merit

The control premium reflects the value the acquirer places on control. What are the sources of that value? Consider five.

1. *The government-protected franchise*: Buying all the target utility's shares gets the acquirer two distinct things: (a) the ingredients of any business—assets, business processes, intellectual property, executive team, knowledgeable employees; and (b) control of the utility's state-granted, exclusive franchise. The business ingredients, by themselves, don't justify paying a control premium. Under conventional cost-based ratemaking, those ingredients comprise the

book value that establishes the commission-set rates—rates that produce the stream of earnings that in turn support the stock market price. Immediately after the acquisition, that book value will be the same, so the stream of commission-authorized earnings should be the same. The control premium therefore reflects something else: the franchise—that exclusive market position granted and protected by state government. That market position results not from the utility's skill or risk-taking; it results from government action.

Also influencing the premium is the acquirer's expectation of persuading the target utility's regulators to approve rates that produce returns exceeding the acquirer's cost of capital, in at least three ways.

2. *Equity-level returns on acquisition debt*: To buy a company is to buy its equity. The acquirer usually pays for its purchase with a combination of cash on hand and proceeds of new issuances of equity and debt. Debt costs less than equity because the lender's risk is lower than the shareholder's risk. If the acquirer can persuade the commission to allow an equity-level return on target equity purchased with debt, the company will have earnings arising solely from financial engineering. To get those extra earnings, the rational acquirer will pay a premium.

3. *Authorized returns exceeding the acquirer's "required" return*: Suppose a prospective acquirer sees that the target utility's regulatory commission recently authorized a return on equity of 10 percent. Suppose also that the acquirer's hurdle rate—its actual cost of equity (i.e., the return sufficient to attract its investment) is only 8 percent. The acquirer will be willing to pay a premium for the opportunity to earn that higher authorized return.

4. *Rates exceeding reasonable cost*: What if the acquirer expects to persuade the target utility's commission to set rates based on cost projections exceeding the acquirer's internal projections? All else equal, that regulatory error will produce an actual return exceeding the acquirer's authorized return, and likely exceeding its required return. For that extra return, an acquirer again will be willing to pay a premium.

5. *What about performance merit?* The prior four contributors to the control premium have nothing to do with the target company's merit. But merit can matter. A poorly financed, indifferently led, sloppily managed utility will have frequent outages, surly employees, high operating costs, unreliable infrastructure and undisciplined money management. The result—low customer loyalty and high regulatory penalties—will push earnings and value down. Excellent management, in contrast, produces high-quality service at reasonable prices, higher customer loyalty and greater regulatory satisfaction. Those positive conditions signal a long-lasting stream of stable earnings and rising value, causing a prospective acquirer to raise its price offer. In those situations, unlike the prior four, part of the control premium will be attributable to the target company's merit. With this caveat: Normal prudent performance is part of the utility's obligation to serve, for which it receives appropriate compensation through commission-set rates. So absent evidence of unique shareholder risk-taking, or of target performance exceeding obligatory prudent performance, the control premium is logically attributable not to performance merit but to one or more of the other four factors.

The Constitution: No automatic shareholder right to the premium

I have explained why the premium should not go, automatically and entirely, to target shareholders: They are not the likely sources of the premium's value. Yet some utility-side witnesses have argued that denying target shareholders 100% of the control premium violates the Constitution because it "takes" private property, in violation of the Fifth Amendment and the Due Process Clause. This argument misunderstands and misuses our Nation's foundational document.

As explained, the premium's primary source is the state-granted franchise, because it produces earnings from customers made captive by that franchise. The franchise is a public privilege created by state government; it is not the utility's private asset to sell for gain. The shareholders own the company and its assets; they do not own the franchise. So they have no necessary right to any part of the control premium attributable to the franchise. What the Constitution promises shareholders is "just compensation." They receive that just compensation when commissions set their utility's rates—rates that provide a reasonable opportunity to earn a fair return on prudent and used-and-useful capital. A control premium on top of that compensation is overcompensation.

Error and correction

Though the main contributors to the premium's value are the captive customers, regulators let the premium go to the shareholders. Commissions make this mistake because they focus on avoiding harm, while merger promoters focus on maximizing gain. A competitive market would produce no such lopsidedness. Effective competition would both discipline the control premium and allocate the transaction's value between the target and its customers objectively. How might regulation replicate the competitive result?

Society, and the economy, are best off when costs go to the cost-causers and gains go to the burden-bearers. Applying this principle to the control premium means allocating it between the target utility's shareholders and customers proportional to each group's contribution to the premium's value.

The ratepayers contribute their captivity: their stable financial support, compelled by government decisions. Merger applicants might respond that (a) ratepayers get what they pay for—utility service; so they deserve nothing more. That is a fair point—but it tells us only that ratepayers do not automatically get the entire control premium. It does not say they get zero and that the shareholders get all.

Shareholders might argue that without their investment there would be no service for the customers to buy. But just as the customers receive service in return for paying rates, those very rates compensate the shareholders for their investment. One cannot say, therefore, that the target shareholders contributed any more to the premium's value than the customers did.

The logical solution is to allocate the premium between shareholders and customers based on their contribution to its associated value. And if the shareholder and ratepayer arguments have equal weight (or weightlessness)? Then, logic and neutrality call for a default result of 50-50.

Why don't regulators apply this logic? I'll address that question in future essays.