Missing From Utility Merger Markets: Competitive Discipline and Customer Benefits

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My third book, Regulating Mergers and Acquisitions of U.S. Electric Utilities: Industry Concentration and Corporate Complication*, will be published by Edward Elgar Publishing in Fall 2020. From February 2020 through March 2021, each monthly essay will excerpt a book chapter. This month's essay excerpts Chapter 2. I hope this essay series, and the book, will stimulate a community-wide discussion on this crucial topic.*

Last month's essay described merging parties' goals—highest price for the target, new earnings streams for the acquirer. If the merged company faces competition, these goals pose no necessary conflict with the public interest. Competition's discipline forces merger negotiators to focus on customer benefits. But in utility mergers, competitive discipline is missing, because the target utility has a monopoly. This absence of competitive pressure makes customer benefits subordinate to shareholder gains.

Merger discipline in competitive markets

Economists distinguish markets based on competitiveness, from hard monopoly to perfect competition. In hard monopoly, a single seller sells to captive customers an indispensable product with no reasonable substitutes, at a price set by the seller to maximize profit. In perfect competition, sellers don't set prices; market forces do. Prices emerge from the intersection of demand and supply curves that reflect the preferences and actions of numerous buyers and sellers. Somewhere between those theoretical markets lie real-world markets. The sweet spot is effective competition—a market whose structure and whose participants' conduct make success depend on merit.

How does effective competition discipline mergers? Because the merged company's customers can shop freely among suppliers, the acquirer is buying an uncertain revenue stream—one that will run dry if the customers prefer a lower-pricing, better-serving competitor. That uncertainty, that competitive threat, disciplines the acquirer's offer price. Competition among sellers for the target's customers disciplines competition among acquirers for the target's shareholders. Market pressures align all three interests—acquirer, target shareholders and customers.

Here's a simple example: You own an apartment building in a city with vacancies; you want to sell it. The prospective acquirer will offer you a price no greater than what the acquirer estimates it can recover through rent levels set by the competitive market. The acquirer's offer price will reflect a premium over the building's current market value (the net present value of the expected stream of earnings from current rentals) only if the acquirer can (a) improve quality, so

she can raise rents; or (b) reduce operating costs, so she can increase profit. The highest price will come from which bidder? From the most quality-enhancing, cost-effective bidder. Competition in the rental market disciplines competition in the acquisition market. Competition aligns all interests—building seller, building buyer and renters.

Mergers in monopoly markets: No competitive discipline

The utility monopoly context shares two facts with the competitive context: The target still will seek the highest price, and the acquirers will base their bids on their expected post-merger earnings. But there will be three differences. First, because the target's customers are captive, the acquirer's earnings stream will be relatively certain. Second, there will be no competition to discipline the price of retail service. Those two facts increase the acquisition's value to the acquirer, producing a higher offer price. Third, because a monopoly market doesn't penalize suboptimal performance the way a competitive market does, the highest offer price will not necessarily come from the best performer. These three factors produce this result: In a monopoly market, the merging parties' interests do not align with the customers' interests.

An acquisition process does involve rivalry among acquirers. When the target serves a competitive market, that rivalry benefits customers because the highest offer will come from the most cost-effective performer. But when the target serves a monopoly market, the competition among acquirers is based not on performance but on price. And the higher the price paid by acquirer to target, the fewer benefits offered by acquirer to customers. By insisting on the highest price, the target utility thus deprives its customers of benefits. Putting its shareholders before its customers, it violates its duty to minimize cost and maximize performance.

Aren't mergers "arms-length" transactions?

In regulatory proceedings, merger applicants often describe their negotiations as "arm's-length." They imply that the transaction's terms resemble what a competitive would produce. This description has two defects.

Defect #1: Negotiations are not truly arm's-length where the two parties have a common purpose. True arm's-length transactions involve adversaries, each seeking to advance its interest, indifferent to the other's interest. But when two companies have a common purpose, they don't negotiate as adversaries. Merging companies have a common purpose—they will become accountable to the same shareholders. So they can't be adversaries. Their convergent interests weaken the market discipline inherent in true arm's-length bargaining.

Defect #2: In a monopoly market merger, the acquirer and target are not adversaries; one's gain is not necessarily the other's loss. The high price demand by the target will not necessarily diminish the acquirer's wealth—not if the merged entity can recover that price from its captive customers. So in utility mergers, acquirer and target don't bargain as adversaries; they collaborate on regulatory strategies. Together they pursue their common purpose: recovering the

transaction price from the merged company's captive customers. Their mutual success depends not on an objective competitive market but on a subjective regulatory process.

Unlike our apartment building example, merging utilities negotiate transaction terms based not on retail prices that competitive markets set, but based on rates they expect to persuade their regulators to set. Then in the merger approval proceeding they seek regulatory decisions that satisfy those expectations. That is the essence of circularity.

The subordination of customer benefits to shareholder gains

Target companies that face competitors want acquirers who will help them beat those competitors. The more cost-effective the acquirer, the more benefits for the customers. Targets serving monopoly markets think differently. Lacking competitors, they face no risk of losing customers. So instead of choosing the acquirer that maximizes benefits for customers, they choose the acquirer that maximizes price for shareholders. Then they design a benefits package sufficient to persuade the regulators. And if regulators don't require of merger applicants the same level of benefits that competition would produce—if regulators accept only the benefits that applicants propose—then customers lose.

Contrast regulatory decisions that replicate competition's pressures. Each utility merger would create new economic value, then allocate that value objectively between shareholders and customers. The acquisition price paid to the target would reflect an earnings stream consistent with that value and that allocation. Regulatory policies that defer to merger proposals, where competition doesn't discipline those proposals, produce mergers with less economic value and fewer consumer benefits than we would see in competitive markets.