“No Harm” Vs. “Positive Benefits”: The Wrong Conversation about Merger Standards

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When I urge utility commissions to create a merger policy, I get one of two responses: “We have no merger pending, so we don't care about it,” or “We have a merger pending, so we can't talk about it.” That doesn't leave a lot of alternatives. A better approach comes from a wise commissioner: “The old maxim of 'buy low, sell high' when applied to policy work would read 'Invest in policy development in quiet times when its value is low in order to have it available in active times when its value is high.'“

A good place to invest is in clearing the confusion over “no harm” vs. “positive benefits”: By which standard should mergers be judged? Without definitions, each standard is meaningless; with definitions, both standards are the same: A merger must maximize benefits for the customers.

What is “Harm”?

In the public utility context, “harm” means “failure to act cost-effectively.” Having received protection from competition, a utility must perform as if subject to competition. It must make all feasible, cost-effective efforts to reduce costs and increase quality. Diverting resources from more productive use—incurring what economists call “opportunity cost”—fails this test.

This opportunity cost principle applies to mergers in two distinct situations. What if a merger precluded some other utility action, including some other merger, that would have yielded more customer benefits? Further, what if a commission approved the merger subject to conditions allowing the applicants to keep gains they'd have given customers willingly? By approving these transactions, the regulator denies customers benefits they'd have received had the utility been subject to competition. That denial—keeping prices above or quality below competitive levels—is harm.

The typical regulatory decision violates this principle. First, it defines harm only as a decline from the status quo. Second, the typical “no harm” test looks only for immediate, tangible harm, in terms of rates and reliability. Doing so ignores less immediate, less tangible harm that can afflict complicated holding company structures: harm from excess debt, internal conflicts for capital, and pressures on local utility management to satisfy holding company goals that diverge from the utility's obligation to serve.

As explained last month, a merger proposal arises from a contest for control (see “Contests for Control: Who Should Make the Rules?”). The acquiree picks the partner offering the most to shareholders, not the one promising the most to customers. In this context, choosing harm avoidance over cost-effective performance produces regulatory deference—to applicants'

business goals at the expense of consumers' welfare. (See “The Dangers of Merger Deference,” Part I and Part II.)

Which doctor would you choose for your child—the one who finds nothing wrong or the one who prescribes the best diet, exercise and sleep practices? Regulation must replicate the pressures of competition. Successful competitors do not rest on their status quo performance. They say “How do I out-do my competitors (both actual and potential), so I can keep my current customers and attract new ones?” To deny customers the benefits of that sentiment, to accept the status quo as the definition of “no harm,” is to do customers harm.

What are “Positive Benefits”?

To have meaning, a “positive benefits” standard must answer two questions.

What benefits? Regulators should count only those benefits uniquely attributable to the merger; i.e., improvements unattainable without the merger. Utilities don't need a merger to fund charitable organizations, to adopt new energy efficiency measures, to build a downtown headquarters building, to buy more renewable energy, to build new broadband or even to send $100 checks to each customer from pre-existing cash reserves. Without a merger, they can share generation reserves by contract, and adopt “best practices” by hiring expert consultants. Yet dozens of merger decisions count these benefits as merger benefits. This is wrong, for four reasons.

First, a commission's jurisdiction is bounded by a statutory purpose: to ensure that a defined service (electricity, gas, water) is provided to customers reliably and nondiscriminatorily, at just and reasonable rates. When the “benefit” neither improves a jurisdictional service nor lowers its cost, it falls outside the commission's jurisdiction. Instead of regulating utility performance, the commission is playing politics—picking and choosing benefits and beneficiaries. And by playing politics the commission commits the second and third errors: arbitrariness and discrimination. The commission acts arbitrarily when it states no criteria supporting the selected benefits and beneficiaries. (Indeed, the typical criterion for a benefit—that the applicants offered it—is itself arbitrary). And the commission acts discriminatorily because the benefits flow to only some residents while the merger's risks and costs fall on all customers. Even the $100 payment to each customer (approved by the Maryland Commission in its order authorizing the Exelon-Constellation merger, where I was a witness for the State of Maryland) is discriminatory: The fixed payment did not vary with customer consumption, and the recipients were only current customers while the merger's risks fall on current and future customers.

Fourth and most important: Unless we evaluate mergers on their merits, we invite consolidation unsupported by efficiencies. The result is “disparity in determination between regulators and the regulated.” When merger strategists aim for market advantage while regulators accept unrelated benefits, we get an industry structure no regulator intended: “No commissioner who approved a simple shell holding company 20 years ago intended his modest

utility to end up one of 20 affiliates in a conglomerate reaching from Florida to Indiana." (See "Preparing for Mergers: A Commission's Bottom Lines.")

How positive? Having received protection from competition, the utility must perform as if subject to competition: It must take all cost-effective actions that reduce ratepayer cost and improve service quality. Applying this principle to mergers means requiring benefits in an amount just short of the point where the applicants will withdraw their merger.

Some call this holding the merger "hostage" for "ransom." (e.g., International Transmission Company CEO Joseph Welch, complaining about conditions recommended by witnesses (including this author) hired by the Arkansas, Mississippi and Louisiana commissions to evaluate ITC's 2013 bid to acquire Entergy's transmission system). Disappointing to merger applicants, yes; inconsistent with elementary economics, no. Were the merger transaction subjected to competition, with the regulator making the rules (See the essay "Contests for Control: Who Should Make the Rules?"), the contestants would bid up the benefits offered, up to the point that their own costs exceeded their benefits.

In the typical merger order, the benefits reflect not what regulatory principle requires, but what the applicants offer. (One exception: The Maryland Commission in 1997 conditioned the proposed BG&E-PEPCO merger on ratepayers receiving a stated portion of merger-related cost savings. While the portion was not defined as the amount necessary to maximize benefits, it exceeded what the applicants were willing to share, because they withdrew their proposal.) Given the applicants' informational advantage and the commission's policy silence, regulatory deference to the applicants will produce benefits below what competition would induce. The damage to the public interest goes beyond a one-time denial of benefits. With the wealth withheld from its captive customers, the merged company can enter new markets, to the competitive disadvantage of non-utility entrants who have no captive customers.

Caveat

My definitions of "no harm" and "positive benefits" imply that a commission could hold a utility responsible for failing to merge. A Maine court decision says otherwise. Seeking to induce Maine Public Service Company and Central Maine Power Company to reduce costs by merging, the Maine Commission said it would "give serious consideration to possible changes in MPS's rates if management fails to pursue the merger." The Supreme Judicial Court of Maine reversed. The Court viewed the Commission's statement as an order to merge, a statutory power the commission did not have. *Maine Public Service Co. v. Public Utilities Comm'n*, 524 A.2d 1222, 1225-26 (Me. 1987). I disagree with the decision. Whether a commission can order a merger is debatable. What is not debatable is a commission's authority to penalize a utility for failing to act cost-effectively. Whether the failure to act is a failure to buy the lowest-cost fuel or a failure to consummate the highest-benefit merger, the effect is the same: a departure from efficiency that no competitive market would tolerate. Nor should regulation.

Conclusion: When Can a Commission Clarify Its Policy?

Our “buy low, sell high” commissioner now faces “the quandary of applying the old tests to current applications (because they were relied on by the proponents) when new tests are now seen to be preferred.” If we define “quandary” as “tough choice,” there is no quandary because there is no touch choice. “Reliance” with a capital “R”—legal reliance—exists only when a company has invested major dollars based on a legitimate expectation of receiving particular regulatory treatment. A utility ordered to build a new transmission line legally relies on the regulator's obligation to set rates to pay for the line. Outside of that situation, market players know (or are legally deemed to know) that government can change its policies. In the merger context, then, to “rely” is only to hope—to hope that a favored policy remains unchanged. Policy change causes inconvenience, but choosing wrong over right is worse.

So there is no quandary. Whether a utility merger statute prescribes “no harm” or “positive benefits,” the result should be the same: a utility obligation to choose the merger that produces the maximum benefit, and provides the full benefits, net of merger costs, to the customers.