# Protecting Innovation during Consolidation:
# The Advantages of Alertness

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How does consolidation affect innovation? In telecommunications and electricity, regulators have approved dozens of mergers without knowing the answer. Antitrust scholars are now grappling with the question, gathering facts and testing theories. My essay “Two Trends in Tension: Does Consolidation Reduce Innovation?” urged regulators to catch up. Four logical steps are to define regulation's role in innovation, assess whether the regulated industries are innovating sufficiently already, predict how mergers will affect innovation, then take necessary actions.

## What is Regulation's Role?

A market is ripe for regulation if two conditions are met: (a) that market, unregulated, performs suboptimally; and (b) the societal gains from regulating are likely to exceed the costs.

To detect the suboptimal, we must define the optimal: What innovations do we want to induce? For telecommunications—is it speeding mediocre movies to the maximum number of gadgets, or is it educating low-income children and delivering medical help to rural citizens? For electricity—is it producing electric vehicles, or is it having houses that offer more comfort with less consumption?

By answering these questions, the regulator converts “innovation” from business buzzword into enforceable commitment. Otherwise, the regulator risks being swayed by applicant advertising—the press release boilerplate that boasts of how the merged company's large size, complementary assets and access to capital will lead to improvements that are rarely specified. Unless the commission converts this posturing into promises—to improve service, reduce costs, or ease entry for competitors—”innovation” is only a slogan to sell the transaction.

## Is the Industry Already Innovating?

With goals established, the regulator can assess whether the industry is innovating to achieve them. If the incumbent utility enjoys an exclusive, government-granted franchise, the answer is not obvious. Although facing no imminent competitive threat, the utility still might seek to innovate, its reasons ranging from a public-spirited wish to please its customers to a private-spirited wish to boost its market value.

Or it could innovate to deter potential competitors. And even a monopoly utility has potential competitors. Regulators want breakthroughs, in customer-empowering energy efficiency, cybersecurity, pipeline leak detection and broadband deployment. A utility that fails

to innovate tests a commission's patience. An impatient commission might just get someone else to do the job, thereby reducing the utility's profit, size and growth potential. Just ask the utilities in Hawaii, Maine, Oregon and Vermont, where the commissions have displaced the traditional utility with newcomers providing energy efficiency services. Where a commission has the power and will to hire the best, the industry is induced to innovate.

## How Might a Merger Affect Innovation?

Having described the desired innovations and assessed the industry's current efforts, the regulator can test the proposed merger: Will it assist or impede the desired innovation? The question requires attention to market structure: Do we need a large company with a large market share, protected from competition so it can raise the capital (and prices) necessary to fund the innovation effort? Or will such a company avoid innovating because the new products will make customers less dependent on the utility? Would the desired innovations emerge more readily from markets with more, smaller competitors—markets where nimbleness is more valuable than size?

Judgments about market structure lead to questions about regulatory technique. If the desired innovation requires a company protected from competition, we need regulatory oversight to guide the innovation toward the public interest. Otherwise, the merged company will innovate for itself: designing products that enhance its advantages over its competitors, instead of products that ease entry for those competitors.

If instead the desired innovation is more likely to come from competition, we test the merger's likely effects on competition. A merger can increase competition by making the merged company a stronger competitor; by, for example, reducing its future fixed costs, thus freeing up funds for innovation. As long as the post-merger market has other strong competitors, or if barriers to entry are low, the merged company's efforts can pressure its competitors to innovate as well. That's the positive outlook. The opposite is also possible: If the post-merger market is not competitive, the merged company can use its fixed cost savings to build more entry barriers and expand into new markets, all while keep prices high and innovation low.

## Innovation as a Distinct Product

This discussion has viewed innovation as an effort to produce goods valued by the regulator. Some economists view "innovation" as an end in itself: a public benefit independent of any particular product, an attribute that differentiates competitors, attracts customers and produces profit. (For examples, see Michael L. Katz & Howard A. Shelanski, "Mergers and Innovation," 74 *Antitrust Law Journal* 1 (2007).) Under this thinking, a merger of two competing innovators could increase or reduce innovation competition, depending on market facts. If the post-merger market has other strong innovators and/or low entry barriers, the merger could increase innovation competition: The merged company's efforts to exploit its new economies of scale or scope could stimulate its competitors to increase their innovation efforts. Or the opposite can occur: If the post-merger market lacks strong innovators, the

merged company could rest on its laurels by reducing its innovation output, or by building entry barriers.

## Alertness Leads to Actions

To consider how consolidation affects innovation, effective regulators take a series of steps. They (a) define the innovations they want, (b) identify the market conditions that will induce companies to produce those results, and (c) assess whether current markets have those conditions. Then they test how a proposed merger will affect those market conditions. With that information gathered and analyses completed, alert regulators can decide whether to intervene, and how.

But not every regulator intervenes, even when innovation is suboptimal and market structure non-competitive. Intervention is risky because innovation is risky and costly. Failure makes ratepayers angry and shareholders itchy. And success can involve "positive externalities," i.e., where costs borne by some produce benefits for others. According to classical economics, positive externalities make markets fail. Where markets fail, society under-invests.

Still, there are grounds for optimism. Most utility mergers trigger reviews by multiple regulatory jurisdictions. The hope is that in at least one of those jurisdictions, regulators will make innovation central to their decision; and, like industry competition itself, stimulate others to do the same.