Suboptimal Couplings Cause Economic Waste

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My essays "Diverse Strategies, Common Purpose: Selling Public Franchises for Private Gain," "Missing from Utility Merger Markets: Competitive Discipline and Customer Benefits," and "Thirty Years of Electricity Mergers: Concentration and Complication No One Intended" explained the transactions: sales of public franchises for private gain, undisciplined by effective competition, producing a concentrated, complicated industry no one intended. Repeated 80 times over 30 years, electricity mergers have wasted economic resources, diverted value from customers to shareholders, weakened competitive forces and intensified intra-corporate conflict. Let's start with economic waste.

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In both competitive and monopoly markets, acquisition targets choose their acquirers based on highest price. In competitive markets, that highest price will come from the most cost-effective performer. Its ability to compete successfully against others creates the expected revenue-to-cost margin that supports its acquisition price. Competitive markets align the interests of acquirer, target and customers.

Monopoly markets don't. Because a monopoly market lacks a competitive market's discipline, the highest-price acquirer won't necessarily be the best performer. If target utilities prioritized performance, competing acquirers would lower their offer prices and their costs, enabling post-merger service at lower rates. The economy gains. But target utilities choose their acquirers based on price instead of performance, so the economy loses. As do customers, because their utility has denied them what they pay for: service at a quality and cost that replicates competitive market outcomes.

But won't the highest offer price necessarily come from the most cost-effective performer? Not in a utility monopoly market, because the final product price is set not by competition but by regulators. The acquirer will base its high-price offer not on its expectation of beating its competitors but on its expectation of persuading regulators—persuading them to set rates above appropriate levels.

"No harm": The wrong benefit-cost ratio

Merger investors seek biggest bang for buck. Most regulators require only "no harm." This simple difference explains why merger gains go disproportionately to investors. No-harm conflicts with regulation's central purpose: to produce outcomes comparable to competition. In regulation, "no harm" means zero gain. In competition, zero gain would get any executive fired.

Competition forces continuous improvement—from horses to jet engines; from smoke signals to the world wide web. No competitive company succeeds by promising customers no harm. If commissions required merger applicants to act like competitive companies, targets would select acquirers based on performance rather than price. All interests would be aligned.

No-harm conflicts with classic prudence analysis. Suppose a utility has a worn-out, $10/hour widget. It buys a new$10/hour widget when an $8/hour widget of equal quality is available. If the utility CEO said, "We were prudent because we caused no harm," she'd be laughed out of the hearing room, and the commission would disallow $2/hour as imprudent. Similarly, a merger should be the least-cost means of producing a guaranteed benefit. No-harm doesn't cut it.

Acquisition cost: Usually ignored

No one buys a rental property just because the rents cover the operating costs. If the rents don't also recover the acquisition cost, the purchase makes no economic sense. So when computing a deal's benefit-cost ratio, the acquirer includes not just operating cost but acquisition cost.

Yet most commissions compare a merger's benefits to its costs without considering acquisition cost. The likely reason: Merger applicants don't seek, at least not explicitly, to recover the acquisition cost from their customers. So regulators view acquisition cost as the acquirer's problem. But if they omit acquisition cost from their benefit-cost review, they can't know if the deal is cost-effective. More economic waste.

Benefit-counting: Common regulatory errors

When comparing a merger's costs to its benefits, which claimed benefits should count as real benefits? Only those that are unachievable without the merger. Yet many merger applicants, and their regulators, include improvements that should happen without the merger. Real merger benefits offset merger costs. Counting ordinary improvements as offsets to costs means that customers effectively bear those costs. Consider two frequent claims: "economies of scale" and "best practices."

Economies of scale: Merger applicants talk of reducing duplication—like in customer billing, corporate accounting, shareholder relations and middle management. Big words, small potatoes. In 100-odd merger cases I've reviewed, in how many did the applicants present an economies of scale study conducted by someone not paid by them? None. In how many did they identify major scale economies not achievable by contracting rather than merging? Again, none.

"Best practices": Applicants' claims of best practices typically consist of generic references to mundane procedures rather than innovations outside the norm. Like any competitive company, a government-protected utility already has a duty to use best practices, merger or no merger. In other words, best practices are achievable without a merger. Replacing

the target's quill pens and Roman numerals with computers and Arabic numbers merely brings prudence to the imprudent. No merger is necessary. As Judge Richard Posner wrote: "I wish someone would give me some examples of mergers that have improved efficiency. There must be some."[1]

Projecting merger benefits means comparing the merged company to the unmerged company, over time. A competitive company must improve over time or lose its customers; so must an unmerged company. When merger applicants attribute to the merger future improvements that should happen without the merger, they inflate merger benefits.

Items unrelated to the transaction: Merger applicants usually offer customers rate credits. If based on fact-based predictions of true merger savings, these payments should count as merger benefits. If not, they are persuasion payoffs. Counting them as merger benefits favors acquirers with cash over acquirers with merit. No sensible school gives students As for donating to the teacher's retirement fund; no regulator should count rate credits unrelated to real merger savings.

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Utility targets choose their acquirers based on price instead of performance. Too many commissions allow this economic waste by applying to mergers a standard of no-harm rather than maximum benefit to cost. And when assessing merger benefits and costs, commissions ignore acquisition cost; while counting as benefits operational improvements a prudent utility would achieve without a merger. By repeating these errors 80 times over 30 years, we make target shareholders better off while making customers, and the economy, worse off. We can do better.

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[1] "*Philadelphia National Bank* at 50: An Interview with Judge Richard Posner," 80 ANTITRUST L.J. 205, 216 (2015) (referring to mergers generally).