The Dangers of Merger Deference I

Scott Hempling
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In the merger context, commissions make themselves marginal. The essays "Merger Proceedings I: Do Commissions Make Themselves Marginal?" and "Merger Proceedings II: Do Commissions Make Themselves Marginal?" described how: Policy voids breed self-interest proposals. Passive procedures emphasize the applicants' private transaction over the commission's market structure vision. Reactivity replaces creativity. Settlements emphasize the tangible and temporary. Unless the merger is overtly "bad," regulators defer.

In regulation, deference has a proper place. The "management prerogative" precedents warn commissions away from running the utility. A regulator can prescribe standards and assess prudence, but must leave decisions to management—if management is pursuing a public interest purpose. So we must ask: Do utility mergers have a public interest purpose?

Merger applicants often assert a public interest purpose, like (1) lowering costs through horizontal or vertical economies of scale, or (2) improving service quality by meshing two companies' skills and strengths. To distinguish these claims from realities, we need other evidence, like (1) the absence of shareholder windfalls arising from a purchase price above book value; (2) a merger-planning process that identified and committed to ways to reduce costs and improve service; (3) symmetrical sharing, between customers and investors, of the transaction's risks and benefits; and (4) regulators' full access to information to verify the results.

But that is not the normal merger proposal. The normal merger proposal—since the mid-1980s I've participated in or studied dozens—has one or more pecuniary purposes that conflict with the public interest. Here are four examples.

Merger Purpose #1: Gain Competitive Advantages in Existing or New Markets

Traversing non-competitive and potentially competitive markets, public utilities often use mergers for two main purposes: (1) to increase their market share in traditional utility markets, by acquiring or merging horizontally with utilities in the same region; and (2) to gain strategic advantage in new product and geographic markets, by combining infrastructure, experience and skills. When seeking support from the financial community, merger partners typically cite their monopoly status as a competitive advantage, emphasizing the stable revenue flow enabled by their government-protected role as a provider of essential services.

It is possible for mergers so motivated to benefit the public, by injecting competition into the target markets. But they have their downsides: distracting the utility's management and diverting its resources, while increasing the utility's cost of capital due to the new business risks in the corporate family. And if the new entrant is government-protected, the competition is

distorted because the entrant's advantages are unearned. Despite dozens of mergers over three decades, there is no unambiguous evidence of public benefit. Yet each new merger proposal asserts that benefits are certain, while deriding opponents' concerns as speculative. The reality is the opposite: The evidence gap makes claims of success speculative, while the realities of failed investments make the warnings factual. These are not the conditions for commission deference.

Merger Purpose #2: Strengthen Financial Condition by Diversifying Income Sources

To fulfill their obligation to serve—which includes standing ready to serve—utilities need financial strength. By both constitutional and statutory law, a utility's obligation to serve is matched by a commission's obligation to compensate. If the utility has regulatory permission to charge rates reflecting prudent costs, and if it incurs costs prudently, financial strength will follow.

Yet applicants often insist they need their merger to "diversify" their income. As a finance principle, income diversification is a good thing, for it grows and protects wealth. But the utility's job is not to grow and protect its wealth; its job is to serve its customers. To serve its customers and remain financially strong, the utility need only charge commission-set rates and satisfy the commission's standards. Growing and protecting wealth is a goal for shareholders, not the utility. Shareholders can grow and protect their wealth by diversifying their investments: by combining lower-risk investments like utility stocks (whose stable profit flow comes from selling services in a government-protected market) with higher-risk investments like real estate or technology stocks. Each shareholder succeeds by diversifying according to her individual characteristics, like age and risk tolerance. A utility that diversifies makes it harder for the shareholder to diversify, because the shareholder has lost a low-risk option. Because diversifying utility income helps neither customer nor shareholder, a merger with this purpose does not deserve deference.

Merger Purpose #3: Diversify "Regulatory Risk" by Acquiring Utilities in Different Jurisdictions

A utility's "regulatory risk" is the risk of displeasing a commission, the risk of having proposals rejected and performance penalized. A single-state utility can diversify this risk by merging with utilities in other states. But as just explained, diversifying business risk benefits shareholders, not customers. Diversifying "regulatory risk" in fact exposes the original utility's customers to new risks. They will have no influence over the new states' decisions: no say in the quality of the commissioners, the sufficiency of commission's staff resources, or in the quality of the legislative process. Yet these other states' decisions can affect the merged company's performance and its finances, with consequences for the original utility.

What diversifying "regulatory risk" means, at bottom, is reducing the utility's risk of adverse decisions by its original state. Think about it. To reduce one's exposure to a

commission is to reduce one's need to be accountable to that commission. That is not a public interest result and does not deserve deference.

Merger Purpose #4: Increase Access to Financial Resources by Growing Company Size

This is the "bigger is better" argument: Larger companies get better access to financial resources. The argument lacks support in both facts and logic. For utilities, proper rates plus prudent performance yields stable revenue flow. That is the safe bet that investors like. If a utility's performance is imprudent (as when its costs exceed the cost basis of its rates), it will face a financial squeeze. But the solution is for the utility to replace its management or for the commission to replace the utility. A merger, by itself, does neither, but it can make things worse. If the outside merger partner brands itself as savior and risk-taker, demanding compensation to play these roles, the risk is rate increases without performance improvement—a result known colloquially as "bailout." (Caveat: For relatively small utilities, it is possible for a merger based on financial access to promote the public interest, as the Vermont Public Service Board found when approving the 2012 coupling of Green Mountain Power with Central Vermont Public Service.)

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Regulatory deference makes sense when the commission and utility have the same singular purpose: improving performance for the customer. For most public utility mergers, the core purpose is one of the four discussed here, each one conflicting with the public interest. The essay, "The Dangers of Merger Deference II," describes more merger factors that argue against deference, factors such as the motivations of other players in the transaction, competitive defects in the merger market, and conflicts of interest within the host utility.