# The Dangers of Merger Deference II

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When addressing mergers, commission deference makes sense if the transaction's purpose is to improve performance for the customer. But for most mergers, utilities have a different goal. My essay "The Dangers of Merger Deference I" mentioned four possibilities: (1) gain a competitive advantage in existing or new markets, (2) strengthen financial condition by diversifying income sources, (3) diversify "regulatory risk" by acquiring utilities in different jurisdictions, and (4) increase access to financial resources by growing company size. This month I describe three other factors that, if present, argue against deference.

## Merger Players Have Diverse Motivations[1]

1. ***Shareholders of the target company*** seek the highest possible compensation, whether in cash (as in a cash-buyout merger) or in the merged company's stock (as in a stock-for-stock transaction).

2. ***Bondholders of the target*** company want assurance that the rating for their debt does not drop due to lower interest coverages, higher debt-equity ratios, or other factors affecting the merged company's ability to repay.

3. ***Executives of the target company***, if they are remaining on the job post-merger, want certainty about their utility's access to holding company resources and insulation from holding company interference. Executives expecting to depart post-merger will want "golden parachutes." For both types of executives, if they own stock in the target company, they will share the goals of the target company shareholders.

4. ***Lenders*** that finance the acquirer's purchase will care about regulatory conditions that affect the income stream necessary to pay off the debt.

5. In a private equity buyout, ***general partners*** expect managerial control free of unnecessary regulation. Both these general partners and the ***limited partners*** (who are passive investors) seek to grow the company's value as quickly as possible so they can take the company public for a profit.

These motivations are not necessarily consistent with a commission's service-improvement goals.

## Merger Aspirants Compete for the Target Shareholders' Favor

Merger proponents often argue that they negotiated at arm's length, implying that the terms were disciplined by competitive forces. The adversarial relations inherent in such negotiations, they say, ensure the merger's consistency with the public interest. This argument makes the common error of importing competitive market theory into a monopoly market context.

It is true that a merger transaction is subject to competition. But it is a competition won by offering the target company's shareholders the highest price, not by offering customers the best possible service. That is where the conflict arises, where the public interest suffers. The higher the acquisition price, the higher the acquirer's debt; the higher the acquirer's debt, the greater its need to raise rates, cut service quality or delay rate decreases. In true competition, the interests of the company and the customer are aligned; in a merger transaction, they are in conflict.

This conflict, between acquisition strategy and customer benefit, exists if the ultimate retail customers are captive customers. An acquirer of a bakery might offer premiums to target shareholders, but the offer is disciplined by the competitive market for baked goods. If the post-acquisition merged company raises its prices to recover the acquisition cost, its customers will buy their donuts elsewhere—or eat oatmeal at home.

That is why commissions must lead, not defer. The target utility has a fiduciary obligation to get the greatest gain for its shareholders. (I know of no utility that seeks merger proposals that put customer benefits first.) If the commission sets no acquisition price, quality standards or post-merger rate levels, the fiduciary obligation will trump the consumer interest. Commission deference removes the arm's-length distance. Negotiations are arm's length when each party risks financial loss. In a merger of monopolies whose regulators defer to the deal, there is no risk of financial loss. The bargaining is not arm's length.

Further, without arm's-length bargaining—without hosting a competition for the customer's favor—the regulator cannot evaluate the merger objectively. Merger proponents often compare their transaction to the status quo, arguing that there is no harm and some benefit. But regulation's purpose is not to avoid harm and produce some benefit. Regulation's purpose is to produce the most cost-effective performance. Because a merger transaction necessarily precludes some other transaction, because $300 million spent on an acquisition premium is $300 million not spent on energy efficiency or other improvements, because the target company will choose the coupling that pays its shareholders the most, rather than the one that benefits its customers the most, deference deprives customers of what real competition can do: force a comparison that ranks the options and reveals the optimal. That is the purpose of regulation.

## The Host Utility Has a Conflict of Interest

The target company's hope for the highest possible premium creates a conflict of interest—a conflict no less severe than if a commissioner held stock in the target company while voting for the merger. The consumer interest might not be ignored, but it is compromised.

When the utility's conflict of interest is combined with its superior knowledge, the danger of deference looms larger. Consider the temporary rate freeze typically offered by applicants. The beneficiary can be customers or shareholders, depending on the facts. If absent the merger the utility's costs would have risen, the freeze is a customer benefit. But if costs would have been stable or declining, the freeze keeps rates above costs (assuming the merger reduces costs). Without a full cost-of-service inquiry, the commission will not know which set of facts applies—but the utility does know. Conflict of interest plus control of information argues against deference. The solution is to eliminate the information asymmetry, by requiring merger applications to include full rate case information, and by conditioning any merger approval on new rates reflecting that information. This treatment makes explicit the merger's financial consequences for all parties.

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Merger deference ignores merger realities. Absent competition or regulation, owner and customer interests diverge. Full competition causes those interests to converge: Companies design their mergers to satisfy the customer. In a monopoly market, they design their mergers to satisfy the regulators. If regulators defer, the interests will diverge, with customer interest subordinate. Next month's essay will describe those merger policies that, like competition cause the interests to converge.

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[1] I am indebted to Stephen G. Hill for this list. See his superb paper, "Private Equity Buyouts of Public Utilities: Preparation for Regulators" (National Regulatory Research Institute 2007).