Mergers and Acquisitions in the Electric Industry: Public Interest Considerations for Legislators and Regulators

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- Utility M&A transactions: Sales of control of public franchises for private gain, undisciplined by competition

- The potential harms and risks: Economic inefficiency, misallocation of transaction gain, weakening of competition, customer risks

- Institutional solutions: Regulatory posture, practices, and infrastructure

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Most of this document draws from my *Regulating Mergers and Acquisitions*, cited above. The book is available for download from the publisher. In this presentation I do not intend to discuss any specifics about the proposed NextEra-Dominion transaction.

I. Utility M&A transactions: Sales of control of public franchises for private gain, undisciplined by competition

A. Common purpose: The purchase and sale of a public monopoly franchise for private gain

1. The transaction's essence: Transfer control of a government-protected, monopoly franchise from current diverse shareholders to a single holding company owner

   a. In a utility M&A transaction, the transacting parties are buying and selling a market position. Understanding this point—and understanding the difference between competitive markets and monopoly markets—is central to understanding these transactions.

   b. In a market that is effectively competitive, a seller's market position comes from the presence or absence of merit—competitive merit.

   c. A utility monopoly market is not a competitive market. In a utility monopoly market, a utility's market position—its monopoly position—comes not from merit; it comes from the state government. Unlike a state senator, who has to compete for her slot every few years, a utility does not regularly compete for its monopoly role. Year after year after year, the utility keeps that role.[2] That exclusive role provides the utility with a relatively predictable stream of government-established earnings. That stream of predictable earnings—from customers of a monopoly service—is attractive to the acquirer. That stream of earnings from the utility's monopoly market position is what the acquirer is acquiring.

2. The acquirer's and target's dual purpose: Monetize the utility's government-protected market position

   a. The target's goal

      (1) The target seeks to sell control of the utility franchise to the highest bidder. That is what I do when I sell my house or car; that is what a utility does when it selects its acquirer.

[2] For more on the subject of exclusive franchises, see Chapter 2 of my book *Regulating Public Utility Performance: The Law of Market Structure, Pricing and Jurisdiction* (American Bar Association 2d ed. 2021).

How do we know? The target is required to file proxy statements with the SEC. In these proxy statements, the target company's management seeks to prove to shareholders that management is maximizing their wealth.

(2) These proxy statements reveal that the target's Board and CEO act as auctioneers—working the phones, seeking bids, then pushing bidders to raise their bids until all but one drop out.

b. The acquirer's goals

(1) The acquirer wants control of the utility's predictable earnings. It wants to buy customers—customers who will always need utility service, customers who can buy that service only from the local utility because of the state government's decision to protect the utility from competition.

(2) The acquirer then can use the target's monopoly position as a platform from which to increase its earnings, in several possible ways:

(a) Increase the acquired utility's rate base by investing in more capital assets—generation, transmission, and distribution assets for electric utilities; new local distribution pipelines for gas utilities.

(b) Use the new revenue from the acquired utility to help finance the acquisition of another utility.

(c) Use the utility's special knowledge of its local markets (that knowledge paid for by the utility customers) to sell new products and services in those local markets.

(d) Balance the acquirer's higher portfolio risks by owning a company whose revenues are relatively low-risk.

c. The mutual goal: Monetize the target utility's market position.

3. Missing from the transaction's private purposes: Customer benefits

   a. When the target chooses its acquirer based on highest price rather than best performance, customer benefits, if any, become incidental. Again: Acquirers compete, and the target utility decides, based on the offer price, not based on promised performance for the customers.

   b. In fact: The higher the price paid by acquirer, the fewer the benefits for the target's customers. Why? Because paying a high price increases the acquirer's acquisition debt, reducing its ability to invest in improving the utility.

   c. When the two companies bring their transactions to commissions for approval, they talk of customer benefits. But those benefits were not the reason for the transaction. Claims of customer benefits serve regulatory strategy, not transactional purpose. They are post-hoc justifications. We know this because the proxy statements make no mention of customer benefits.

B. Missing from utility M&A transactions: Competitive-market discipline

1. Consider a merger in a competitive market—say, two restaurants in a town with ten restaurants. The target will seek the highest possible purchase price. But that desire for highest price faces a practical cap: the new merged restaurant has no hold on its customers. They can eat elsewhere. So competition among restaurants forces the transacting companies to align their interests with the customers' interest. The motivation for the merger has to be how best to please the customers.

2. An acquisition of a utility monopoly is fundamentally different. Competitive market pressure is missing because customer freedom is missing.

3. This absence of competitive pressure means that prospective merging partners need not focus on creating customer benefits. They can subordinate customer benefits to investor shareholder gains, yet suffer no loss of earnings.

4. Mergers in competitive markets have no choice but to plan and design their transaction to create new value for customers. Monopoly market mergers are different. By increasing the acquirer's debt and reducing competition, these transactions are more likely to divert value from customers.

II. The potential harms and risks: Economic inefficiency, misallocation of transaction gain, weakening of competition, customer risks

A. Regulation's central concerns: Performance, and the conflicts that undermine performance

1. The purpose of all regulation is to maximize the regulated industry's performance. Performance for whom? For the customer, because as the legendary management scholar Peter Drucker wrote years ago, the legitimate purpose of all business is to serve the customer.

2. One can theorize about positive results from utility mergers, such as realizing economies of scale and scope, and strengthening both companies financially. But after 40 years of utility mergers, no one has shown that any of these nearly 100 transactions has improved utility performance for customers. There is no proof that larger utility holding systems operate more cost-effectively than the preexisting arrangements. There is no proof that a utility monopoly that already has ample access to capital has better access to capital when acquired by a larger company. This gap in evidence should come as no surprise, since as discussed above, the main motivations for targets and acquirers have no included improved performance for customers.

3. Again: For competitive markets, the pressure to perform—to make the customer the priority—comes from market forces—forces that align the shareholder interest with the customer interest. For utility monopoly markets, where is little or no competition, the pressure to perform must come from regulatory decisions. In applying that pressure, the first step is to identify and address the unavoidable conflicts between the private interest and the statutory public interest. Those conflicts arise in the four areas discussed next.

B. Suboptimal couplings cause economic waste

1. I have explained that in choosing acquirers, the target utility elevates price over performance. Because a monopoly market lacks a competitive market's discipline, the highest-price acquirer won't necessarily be the best performer.

2. There is a risk that commissions will either overlook this misplaced priority, or instead accept it as normal. Commissions tend to focus on avoiding harm, instead of insisting on the most cost-effective couplings.

Across the industry, there is much debate about what "no harm" means, and whether it is the standard that maximizes industry performance. Consider:

a. The investors' standard: For a given risk level, highest possible return.

b. If the merging companies seek the highest possible return while the regulators seek no harm, the results are predictable: Whatever are the true economic gains from the transactions, their allocation will be lopsided: More to the investors, less to the customers. That result would never occur in a market subject to effective competition. It can occur only in a monopoly market, like a utility market.

c. No-harm conflicts with classic prudence analysis that utility regulators have applied for a century. Suppose a utility has a worn-out widget. Say its operating cost is $10/hour. As a replacement, the utility buys a new $10/hour widget though there is available an equally effective widget at $8/hour. If the utility CEO said, "We were prudent because we caused no harm," no commission would accept that result. But in utility mergers, some commissions do exactly that.

C. Merging parties divert franchise value from the customers who created the value

1. Background: The control premium is the price that the acquirer pays for control.

   a. When an individual investor buys stock, she buys only a sliver of the company. Her sliver gives her no influence, so she pays only the market price.

   b. But in a utility monopoly merger, the acquirer buys more than stock; the acquirer also buys control. So the acquirer pays more than the market price. That excess of purchase price over market price is the value of control—the control premium.

   c. The control premium is the price paid for control. The control premium represents the value to the acquirer of controlling the target's exclusive, government-protected franchise.

2. In transactions that have a control premium—and that is most of these transactions—the shareholders of the target keep 100% for themselves; the customers get zero.

3. The question is whether this outcome makes sense. The sources of the control premium's value are mostly unconnected to the target utility's merit. Those sources include:

    a. Captive ratepayers' support of the target's government-granted franchise

    b. Acquirer's expectations—

        (1) that regulators will set the target's rates above the target's reasonable costs;

        (2) that regulators will authorize equity-level returns on acquisition debt;

        (3) that regulators will set authorized returns exceeding the acquirer's "required" return (as Warren Buffet has stated; see https://oilprice.com/Energy/Energy-General/Warren-Buffett-Regrets-Owning-Electric-Utilities.html); and

        (4) that regulators will base the merged company's rates on commission-approved cost projections that exceed the acquirers' own projections.

    c. Bottom line: The value of control derives largely from the customers' captivity rather than the target's performance merit. Yet the gain from selling control goes largely to the target's shareholders. That result seems to depart from logic and symmetry.

D. By changing market structure, mergers affect industry performance

1. A market's structure determines the vigor of competition. The number of buyers and sellers, the ease of entry and exit, the clarity of market rules, all affect the quality of competition.

2. Market structure matters because the level of competition affects sellers' conduct—and therefore the quality of the sellers' performance for customers.

3. Mergers change market structures. Horizontal mergers reduce the number of competitors. Vertical mergers give the merged company control of important inputs.

4. The electricity merger trend is creating tension with other policy goals. Many states are seeking to decentralize and demonopolize supply, by encouraging community joint purchasing, and solar panels; and by allowing the competitive entry of generation sellers who are not traditional monopoly sellers. But at the same time, commissions are allowing utility mergers to consolidate their control of key assets—like the transmission and distribution highways, and the large-scale generation that produces the electric current that travels on those highways.

E. Hierarchical conflict: A separate source of customer harm

1. At the top of the merged company is a holding company. A holding company has no statutory obligation to utility customers. So its private, for-profit aspirations can conflict with its utility subsidiaries' public service obligations. Here are four categories of concerns.

2. Parent-utility conflict: Business differences, hierarchical control

    a. Holding company and utility subsidiary: Differing objectives

    b. Hierarchical control: Subordinating utility needs to holding company aims

    c. Pressure for growth: Adding to parent-utility conflict

    d. Substantive conflicts: Generation, transmission, renewable energy, distributed energy

3. Merger overcharge risks

    a. Regulatory lag: A path to excess returns

        (1) Who gets the merger savings—ratepayers or shareholders?

        (2) Who decides—commission or company?

    b. Double-leveraging: Another path to excess returns

4. Acquisition debt risks

   a. To acquire a target, the acquirer usually has to borrow money. Acquisition lenders are nervous. They want assurance of repayment. So they want the acquirer to control the target utility's financial resources, even to limit its spending.

   b. If the acquirer defaults, its creditors can become the target utility's owners. Not what the regulators had in mind.

5. Nonutility business risks: Within the typical utility holding company today are not only utility businesses but also nonutility businesses. The simultaneous presence of both types of businesses in one holding company system creates several concerns:

   a. Will the presence of higher-risk nonutility businesses affect the cost of capital to the utility businesses?

   b. Will utility ratepayer be paying for investments that will support the nonutility businesses?

   c. Will the risks and complexities of the nonutility businesses distract executives from their responsibility to excel in providing utility services?

III. Institutional solutions: Regulatory posture, practices, and infrastructure

To make private-interest mergers serve public-interest goals, regulators need to replace deference with action.

A. Start with vision

1. Identify the mix and quality of services that utility customers need and want.

2. Describe the types of companies most able to provide those services cost effectively.

3. Determine the market structure—competition or monopoly—most suitable to attract and maintain the companies.

B. Establish selection criteria for types of acquirers and types of transactions

C. Create filing requirements that force comparisons between the proposed merger and the commission's vision

1. Purpose: Bring out the full transaction story: Why is the acquirer buying control? Why is the target selling control? Why this acquisition price? What changes in governance, operations, capital expenditures and financing will the acquirer make? What is the off-ramp if there is harm?

2. Filing requirements: ten categories

   a. Transaction purposes and goals
   b. Transaction form and terms
   c. Transaction costs and transition costs
   d. Capital structure
   e. Acquisition cost
   f. Risks of harm
   g. Benefits
   h. Corporate structure and governance
   i. Competitive advantages
   j. Merger history

D. Hold a contest to find the most cost-effective couplings

1. Shape investors', executives' and workers' incentives so that the merged company produces that mix and quality cost-effectively

2. Discourage, limit or prohibit any business activities, corporate structures and financial arrangements that conflict with, or distract from, the utility's mission.

3. Must-haves

   a. Specific experience providing the desired services with excellence.

   b. Financial capability to execute the purchase and finance future utility investments.

   c. An executive compensation system that aligns pay with operational performance and that gives executives no reason to pursue shareholder interests that conflict with customer interest

   d. An internal disciplinary system that makes company wrongdoers fully accountable for their wrongdoing.

e. Productive labor relations, including third-party audit procedures that ensure fair pay, health, and safety for all employees.

f. A record of respect for the regulatory process, including its key features: candor, transparency and reliance on facts, logic and law instead of less rational forms of persuasion.

g. Diversity at all levels of the company, reflecting the diversity of the service territory's population.

h. For non-U.S. holding companies, a home-country legal infrastructure (including accounting rules, regulatory practices and corporate transparency) that is compatible with U.S. law and accessible to U.S. regulators.

4. Must-not-haves

a. A record of law-breaking or rule-breaking.

b. A record of poor performance in other franchises.

c. A record of anticompetitive practices, or of opposition to competition where competition can improve performance—such as competition that allows qualified, cost-effective companies to compete for roles currently performed by the incumbent utility.

d. Control of facilities that would give the merged company horizontal or vertical market power in any market, or contribute to a concentration trend that could reasonably lead to market power, unless regulators can remove that market power fully.

e. Control by a holding company system that is overly complex, overly leveraged or overly invested in businesses whose risks or strategies undermine or conflict with a utility's obligation to serve.

f. Asymmetrical compensation plans—ones that reward risk-taking executives for the upsides but make shareholders, creditors and customers bear the downsides.

5. Discretionary haves

   a. A culture of experimentation and innovation.

   b. Willingness to forgo additional acquisitions, of specified magnitudes and types, without commission permission aimed at preserving economies and preventing distractions.

   c. Active, educated board members who are not over-compensated relative to their value.

   d. Compensation systems for executives and employees that reward good work appropriately, including a non-excessive ratio of CEO compensation to line-worker compensation

   e. Type of ownership (e.g., government-owned vs. investor-owned, private equity vs. publicly traded, mutual funds vs. hedge funds).