A Merger Denied: Now What?

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Since the modern electricity merger trend started in the mid-1980s, state commissions have approved nearly 100 electric utility acquisitions. I have addressed this trend with a series of essays—sketches for a book I will complete in 2017. The first essay ("Utility Mergers: Who Has a Vision?") introduced the problem. Because mergers of monopolies are not disciplined by competitive market forces, regulatory policies must align merging companies' interests with the public interest. They don't. When no state has a clear vision for its corporate structure future, we get results that no one intended. Consolidation among investor-owned utilities has reduced their number by half, while leaving many of our local utilities

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owned by conglomerates. Electric utilities are no longer your grandparents' nest eggs, removing a historically important option for conservative investors (and therefore a source of low-cost capital of benefit to consumers).

Over this 30-year period, state commissions have rejected mergers only four times: Southern California Edison and San Diego Gas & Electric (California 1991); Unisource (the holding company of Tucson Electric) and Kohlberg, Kravis Roberts (Arizona 2005); Portland General Electric, Texas Pacific Group and others (Oregon 2005); and Northwestern Utilities and Babcock and Brown Infrastructure (Montana 2007). Now we have a fifth: the Hawai'i Commission's rejection, in July 2016, of the acquisition of the Hawai'i Electric Company system by NextEra (the holding company of Florida Power & Light).[1] (Full disclosure: I was a witness in the case for the State of Hawai'i.)

The Hawai'i order contained an Appendix A, entitled "Commission Guidance for Any Future Merger or Acquisition Proceedings." This addition is unusual and praiseworthy. In rejecting a merger, most state commissions merely say "no," giving no guidance for the future. I have consulted for the Hawai'i Commission on nearly a dozen occasions, and have great respect for its professionalism, especially what it has achieved with limited resources. But its Guidance document has two problems, each of which goes to the heart of how mergers affect the public interest. If each state would replicate the Hawai'i Commission's thoughtfulness, while filling these two gaps, electric utility mergers could benefit the public interest.

The central conflict of interest: purchase price vs. customer benefit

In every acquisition I have studied, the target company's board has one priority: obtain for its shareholders the highest possible price. Proxy statements filed with the Securities and Exchange Commission describe how the target CEO works the phones, causing prospective acquirers to bid up the price. Also clear from these narratives is that customer interests receive no attention—until after the deal has been signed. To sell the transaction to the regulators, the merging companies work from a list of standard claims ("merger synergies," community contributions, temporary rate freezes) that play no part in the reasons for the transaction. The Hawai'i transaction was no different. The result—typical for electric utility mergers—was a lopsided allocation of benefits. HEI shareholders were promised a premium of $568 million; ratepayers would receive a rate benefit of $60 million.[2]

[1] "Order 33795, Dismissing Application Without Prejudice and Closing Docket" (July 15, 2016).

[2] There were other "benefits" offered, but they were minor. Some were merely commitments to obey the law.

Consider dentistry. A retiring dentist sells her practice to the highest bidder. Out of concern for her patients she will verify the buyer's minimum competence. But her priority is retirement funds, not patient satisfaction. And there are, of course, many dentists. So if the patients dislike the successor, they can go elsewhere. In Hawaii, the HECO companies' board chose NextEra like a dentist chooses a successor: purchase price first, customers second. But unlike the dentist's patients, HECO's customers cannot go elsewhere.

Hawai'i's Appendix A leaves this unsatisfactory situation in place. The result is predictable: The Hawai'i utilities will receive more acquisition offers, each one offering gains to shareholders. The target will choose the bidder offering the highest price. (Who wouldn't?) The two companies—acquirer and acquiree—will then present to the Commission a transaction whose sub-optimality is papered over with the standard list of low-value commitments, the actual value of which is but a fraction of what the target shareholders will receive. There will be another 10-month proceeding to rake over the details, and possibly to negotiate minor improvements. But the fundamental conflict—of purchase price prevailing over customer benefit—will remain.

Target company boards do have a state law fiduciary duty to maximize their shareholders' wealth. But that fiduciary duty is always subject to obligations imposed by federal and state law and policy. Otherwise companies could, without legal consequence, emit toxic waste, pay their workers sub-minimum wages and ignore any other law that conflicts with maximizing shareholder gain. This logic applies to utilities. A target company's duty to maximize its shareholders' wealth is constrained by its state law obligation—as defined by the commission—to provide the customers the most desirable and cost-effective service.

When a professional orchestra needs a new trumpet player, the decision is based on technique and musicality, not on who writes the biggest check. Why should utility acquisitions be different? If the target's board puts customer service first, it will screen prospective acquirers based on their ability to meet the state's needs. The finalists then would compete by offering commitments on cost and quality. Only then, having obtained customer commitments through competition, would the survivors compete on what they offer shareholders. Neither the Hawai'i Commission's policy, nor any other state's merger precedent, follows that thinking. The result is an industry that is consolidating based on factors disconnected from the public interest.

The 'benefits' standards gives customers the short stick

The Hawai'i Appendix states that the benefits to consumers should have a "value that is commensurate with costs and risks assumed by customers as a result of the merger/acquisition." Reread that phrase. The customer "benefit" nets to zero, because it's merely commensurate with their costs and risks. The target shareholders get the highest possible return; the customers' benefit nets to zero. I am not making this up. Appendix A, literally and explicitly, subordinates ratepayers to shareholders.

Appendix A does say that the benefits "must provide net positive value to consumers." But the Commission does not say how much value. It could be token; it could be $60 million in minor rate benefits, compared to the $568 million in shareholder premium. And Appendix A does properly refer to benefits like "grid improvements, improvements in safety and reliability, etc." But these benefits are part of the obligation to serve. They are not "extras" that compensate for the merger's costs and risks.

Utility customers deserve better. If the competition to buy utilities were first a competition to better serve the customer, the benefit to customers would not be net zero; they would reflect what the winner had to offer to beat out its competitors. This simple concept is readily understood by every layperson I know. Why does it play no role in merger proceedings?

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States need merger policies that attract transactions whose central purpose is customer service rather than corporate portfolio expansion—policies that align the transactional interest with the public interest. Such policies are not anti-shareholder. They are pro-shareholder—for the shareholders of companies whose couplings are grounded in customer service. If each state can replicate the Hawai'i Commission's thoughtfulness, while adding the above concept—rooted in the utility's and the regulator's duty to assure that the transaction is in the best interest of customers—we will have, finally, a merger policy that works for both shareholders and consumers. ■