APPA

American Public Power Association
2301 M Street, N.W.
Washington, D.C. 20037
202-467-2900; fax: 202-467-2910
www.APPAnet.org

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Antitrust Modernization Commission
Attention: Public Comments

Last fall the American Public Power Association (APPA) issued two papers addressing merger activities, particularly as related to the electric utility industry. It was recently suggested to us that the Antitrust Modernization Commission (AMC) might have an interest in these papers. Although AMC's due date for comments on these topics has passed, the time-line for the AMC report indicates that staff is still in the drafting phase of the report. Thus APPA is encouraged to believe that that AMC might be able to make use of these two reports.

The first paper – "The Post-Merger Experience" – responds to AMC's request for comments on merger enforcement, specifically in regard to questions raised by AMC on efficiencies in merger analysis.

The paper reviews the recent history of mergers, and surveys reports and studies that explain why mergers fail and what merger failure means for industry finance. The first part of the report looks at whether or not mergers live up to expectations. The evidence demonstrates that promises of major cost savings and financial gain go unfulfilled in a majority of cases, especially as far as utility mergers are concerned. The second part relates the skepticism that credit analysts have developed about utility mergers, and analyzes the deleterious impact mergers can have on utility credit ratings. Finally, the third part examines how management overlooks the potential perils of mergers, and explains why mismanagement is a significant contributing factor to failed merger activity.

The second paper – "The Electric Utility Industry After PUHCA Repeal: What Happens Next?" – responds to AMC's request for comments on regulated industries, specifically in regard to electric utilities.

The paper discusses changes to the oversight of electric utility mergers enacted as part of the Energy Policy Act of 2005, and the resulting potential for greater industry concentration and the exercise of market power. Companies are now free to propose mergers of geographically remote utilities and can pursue diversification strategies beyond those businesses related to the electric industry. Utility ownership is easier for both foreign companies and companies outside of the industry. For example, General Electric and General Motors can now propose to buy regulated electric utilities. The effect will likely be greater consolidation of the electric industry, greater concentration of ownership, more complex company structures, and more opportunities for the exercise of market power. Current wholesale electric markets are not fully competitive and cannot be until underlying structural issues are addressed. Greater concentration in ownership of generating assets will only add to the structural problems, increasing the potential for market manipulation. The increased number of affiliate relationships and large and complex corporate structures will make it more difficult for regulators to monitor financial transactions between affiliates.

While the paper does not address the role of antitrust agencies in the review of electric utility mergers, nothing in the Energy Policy Act of 2005 changed these agencies' ability to review these mergers. Given the potential for increased structural problems in the industry, all agencies with merger oversight must make good use of their powers to ensure that the public interest is protected. APPA's paper recommends several important actions:

- Conducting in-depth merger reviews that require compelling evidence of merger benefits and a complete accounting of merger costs;
- Emphasizing the importance of industry structure on the development of competitive wholesale markets by disallowing—or imposing strong divestiture requirements—on mergers and acquisitions that increase market concentration;
- Establishing stringent regulations limiting financial transactions between the utility and its affiliates; and
- Examining holding company books and records on a regular basis.

APPA submits these comments in the hope that they will prove valuable to the Commission. Thank you for your consideration.

Sincerely,

Diane Moody
Director, Statistical Analysis

Enclosures – 2

The Post-Merger Experience

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American Public Power Association

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2301 M Street, N.W., Washington, D.C. 20037-1484;
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THE POST-MERGER EXPERIENCE

The repeal of the Public Utility Holding Company Act of 1935 ("PUHCA") paves the way for a spate of mergers in the utility industry. But mergers took place regularly in the electric utility industry before PUCHA repeal. The past decade has witnessed several large and small mergers as companies sought to consolidate. Large utility companies see mergers as growth opportunities, believing that they can achieve financial rewards through the acquisition of new capacity and through synergy-related savings. Merger advocates also suggest that these consolidations will provide an incentive to build more generation as innovative players enter into a broader market that operates under a clearer set of unified rules. Larger companies, it is assumed, will have more capital to invest in infrastructure development.

Utility mergers are especially unlikely to deliver the same benefits achieved in other industries.

Post-merger analysis, however, does not confirm these optimistic expectations. Mergers are not always unsuccessful, but by and large mergers do not result in the hoped-for gains. Utility mergers are especially unlikely to deliver the same benefits achieved in other industries. Expected synergies seldom materialize, and companies may not recover their initial investment. These financially risky transactions can end up harming the credit rating of the acquiring company, and in turn both stockholders and customers feel the pinch as the utility seeks to compensate for its overvalued investment.

This article looks at the recent history of mergers, and surveys reports and studies that explain why mergers fail and what merger failure means for industry finance. The focus here is specifically on the utility industry, but mergers in other industries are also considered for the lessons they impart.

The first part investigates all types of mergers and scrutinizes their ability—or inability—to live up to expectations. The evidence demonstrates that promises of major cost savings and financial gain go unfulfilled in a majority of cases, especially as far as utility mergers are concerned. The second part relates the skepticism that credit analysts have developed about utility mergers, and analyzes the deleterious impact mergers can have on utility credit ratings. Finally, the third part examines how management overlooks the potential perils of mergers, and explains why mismanagement is a significant contributing factor to failed merger activity.

Merger Costs and Stock Prices

One of the principal justifications for mergers is that they will produce greater efficiencies and streamline costs. For example, if a utility with a peak load in the summer merges with a utility with a peak load in the winter, then the merged utility will have a higher load factor that maximizes the use of its generation assets.

The statistical evidence does not always support this idea. Raymond Hartman cites numerous studies showing that pre-merger predictions of cost-savings are incorrect for most mergers, and that between 60 and 80 percent of all mergers are unsuccessful. The major reasons are overestimation of benefits and underestimation of the difficulties in integrating the merged firms.[1] In regard to the utility industry, Hartman reviews studies that quantify the relationship between cost and firm size. His summary of these studies demonstrates that predicted scale and scope economies are realized when small utilities merge, but larger utilities are not as successful in realizing efficiency gains.

> All of the studies find significant increasing returns to scale in electricity for smaller utilities and constant or decreasing returns to scale for large utilities. Minimum efficient firm size (MES) for the bulk of the studies is in the range of 2,000–4,000 MW of capacity; 9,000–30,000 GWH of net generation; and 10,000–35,000 GWH of sales."[2]

Thus, according to Hartman, utilities smaller than about 10,000 gigawatt-hours of net generation are much more likely to experience efficiency gains when they merge than larger utilities, because there will be more opportunity to exploit scale economies.[3]

This is in line with traditional economic thought. Economies of scale produce efficiencies up to a point, but eventually there are diminishing returns. The opportunities for making further cost reductions by increasing size or volume are exhausted.[4] Moreover, when both of the

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1 Raymond Hartman, "The Efficiency Effects of Utility Mergers: Lessons from Statistical Cost Analysis," 17 *Energy Law Journal* 425 (1996), pp. 437–39.

2 *Ibid.*, p. 443.

3 *Ibid.*, p. 452.

4 F. M. Scherer, *Industrial Market Structure and Economic Performance, Second Edition* (Chicago: Rand McNally, 1980), p. 84.

merging firms are producing the same product it is much more difficult to streamline operations and achieve production scale economies.[5]

"...respected economic research has found that many, perhaps most, mergers do not lead to significant reductions in cost...."

The American Antitrust Institute ("AAI") recently filed with the Antitrust Modernization Commission ("AMC") comments calling for stricter merger review.[6] AAI questions the currently dominant presumption that mergers—even at high levels and changes in industry concentration—are almost always efficient. AAI's additional submission states:

> National merger policy since 1981 has rested on the assumption that most mergers generate important efficiencies and therefore significantly contribute to consumer welfare. This is reflected in the fact that, typically, only 2–3% of mergers large enough to require federal pre-notification are pursued to the second request level of investigation. Yet, respected economic research has found that many, perhaps most, mergers do not lead to significant reductions in cost, although a small proportion of horizontal mergers have led to very significant efficiencies. Many of the predicted efficiencies of mergers have failed to materialize.[7]

AAI argues that claims that mergers will result in efficiency benefits should be viewed with caution and less weight should be given to predicted long-term benefits. Additionally, the anti-trust agencies reviewing mergers ought to consult independent observers and examine the track record of merging companies in achieving efficiencies in prior transactions.

Peter N. Rigby, a director for Standard and Poor's, is doubtful of promised merger cost-saving benefits in the utility industry. "Some companies merge on the hope that there will be synergies that result in cost savings, but history has shown that they often aren't achievable," he said, and then added, "With some mergers years have passed and we are still looking for the cost savings that were promised. The market will be more skeptical about realizing those synergies."[8]

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5 *Ibid.*, p. 133.

6 Comments of the American Antitrust Institute Working Group on Merger Enforcement, July 15, 2005, p. 3.

7 Statement of the American Antitrust Institute on Horizontal Mergers and the Role of Concentration in the Merger Guidelines, February 10, 2004.

8 Quoted in Michael T. Burr, "Squeezing Synergies," *Public Utilities Fortnightly*, October 2004, p. 50.

Why do cost-savings not materialize as expected? One explanation is the lack of competitive pressure when mergers produce companies with greater market power and monopoly-like stature. Businesses begin to tolerate "x-inefficiency"—or costs that are higher than necessary because a firm is operating inefficiently—when there are no competitive pressures. As Adam Smith noted, "monopoly ... is a great enemy to good management."[9] In short, firms with monopoly power may not feel compelled to develop cost-cutting measures and therefore tolerate inefficient operations because there is no competitor breathing down their necks forcing them to lower prices. Also, firms are more willing to make wasteful expenditures in order to defend their monopoly positions.[10]

Another cause of merger failures—though admittedly more difficult to quantify through statistical evidence—is that merger activity distracts managers from their normal day-to-day activities. They become so engrossed in trying to finalize the merger deal that they may hamper their ability to realize more long-term benefits for the company.

The very nature of the utility business can preclude it from realizing the gains that mergers in other industries produce. The basic utility business is selling a rate-regulated commodity product in a set service territory. Michael Burr, in his article on merger synergies, observes that "Utility mergers are often solid, accretive transactions, but they rarely represent truly transformational propositions."[11] Moreover, one Morgan Stanley managing director notes the difficulty in achieving high growth rates through utilities.[12] In other words, utility mergers do not offer the same kind of dynamic potential that exists in other markets.

This is borne out by the evidence. Various studies have demonstrated that not only do utility mergers often fail to deliver cost reductions, they also have not proven to be valuable bonanzas for utility company stockholders. One survey of 21 U.S. utility mergers showed that while 18 of the 21 target firms displayed a significant increase in stock value at the time of the

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9 Scherer, p. 464, quoting Adam Smith, *Wealth of Nations.*

10 *Ibid.*

11 Burr, p. 50.

12 *Ibid.*

merger announcement, in only six cases was there a significant increase in value for the "combined" firm (acquiring company and target company).[13]

S.R. Rajan goes one step further and attempts to establish a concrete means of judging the value of a utility company. He and his firm, Stern Stewart & Co., developed a measurement called "EVA," or economic value added, a tool designed to measure how far a utility's value exceeds the value of capital investment.[14] His study measures the market value ("MV") of total capital (equity and debt), market value added ("MVA"), which is how much the market value exceeds the amount of capital invested, and standardized MVA, which is the ratio of MVA to the amount of capital invested. These measures provide a method of judging the success of acquisitions. A successful acquisition should produce positive market value added, or in other words, the market value of the firm should increase more than the capital invested in the acquisition.

Rajan's study shows that the largest utilities tend to have the largest market value added, but they do not have the largest standardized MVA, which measures how efficiently capital is invested, or how much wealth is created from capital investments. Duke Energy was one of the only large firms in the study that had consistently invested capital in an efficient manner.[15] Rajan concludes that "it appears that *as utilities grow larger, they create less MVA per dollar of capital invested.*"[16] He posits two reasons for this:

> It could be a sign of governance failure, *i.e.,* the tendency for larger companies to insulate managers from the pressures of accountability and incentives of ownership.
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> Large utilities tend to have more regulatory visibility. They may be "too big to succeed," and they may be denied the opportunity to earn a high return on large capital bases.[17]

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13 S. Berry, "Excess Returns in Electric Utility Mergers during the Transition to Competition," 18 *Journal of Regulatory Economics* 175 (2000), p. 180.

14 S.R. Rajan, "Turning Capital to Wealth: A Ranking of U.S. Utilities," *Public Utilities Fortnightly*, December 1999.

15 It should be noted that Dr. Rajan conducted his study in 1999, and subsequently Duke has sold off many of its assets, including the Empire State Pipeline, solid waste energy facilities, and other pipeline and generation facilities.

16 Rajan, p. 40.

17 *Ibid.*

Another Rajan study used the EVA analysis to examine utility mergers and found that about half severely hurt the stockholders of the acquiring companies. The study concluded:

> Acquiring firms will continue to pursue accounting earnings, reduce the value of their shares in most mergers, and fail to deliver the operating performance implied in the premiums they pay over market value. Merger negotiation and integration will distract utility management from the serious business of improving their operating and capital efficiency, and changing the "guaranteed rate of return" mentality of their employees.[18]

The Effect on Credit Rating

Not only have utility mergers generally not produced synergy-related cost savings, but they potentially harm the credit ratings of the companies involved. This has been the consistent warning of the analysts at Standard and Poor's ("S&P"), one of the three major ratings agencies. An S&P report published in December 2004 notes that credit is a secondary concern to merging companies, and therefore they ignore risk factors that can endanger their credit rating.[19] As an *Electric Utility Week* article summarizes:

Utilities engaging in mergers can harm their credit rating because they face increased regulatory risks and acquire additional debt.

> Pressured by the equity markets, utilities pursued business strategies outside their core competencies such as energy marketing and trading, merchant power, and foreign utility acquisitions. Most of them used up discretionary cash flow and produced little or no return, so managements are now touting "back to basics" strategies.[20]

Utilities engaging in mergers can harm their credit rating because they face increased regulatory risks and acquire additional debt. Regulatory agencies might cut into any potential cost savings by passing them on to customers through rate freezes or reductions. Furthermore, the utility often takes on substantial additional financial risk, and if the merger falls short of expectations, they leave themselves little room to maneuver.

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18 S.J. Raja and Martin Ellis, "Ten Energy Mergers and How They Stack Up," *Public Utilities Fortnightly*, April 1, 2000, p. 37.

19 Jeff Wolinsky, "The Effect of Utility Mergers on Credit: Two Case Studies," December 8, 2004, p. 1.

20 "Pressure to merge could lead to deals negative for credit quality, says S&P," *Electric Utility Week*, December 13, 2004, p. 23.

The 2004 S&P report analyzed two specific mergers: that of FirstEnergy and GPU and that of Potomac Electric Power Co. and Conectiv. All of the involved companies saw their credit ratings decline or change to a negative outlook.

The report catalogues the events that led to the mergers and why they resulted in lower credit ratings. FirstEnergy viewed GPU as a high growth opportunity, especially as compared to its slow-growth service area in Ohio. FirstEnergy incurred nearly $10 billion in debt in financing the deal, and counted on receiving substantial cash from stranded cost recovery in Ohio and the sale of GPU's foreign assets to offset some of this debt. However, FirstEnergy garnered $750 million less than anticipated through asset sales and could not repay debt as quickly as planned. The merger's failure to live up to financial expectations is a principal factor—along with poor or average relationships with regulators in New Jersey and Pennsylvania—for its lowered post-merger rating.

PEPCO Holdings also accumulated substantial debt to accomplish its merger with Conectiv. PEPCO hoped to make up for this accumulated debt through post-merger synergies and cost-cutting, but thanks to a series of "adverse events" that have befallen the company, S&P has failed to identify any discernible savings. Therefore, PEPCO Holding's credit rating suffered as a direct result of its accumulation of additional debt. Not only have synergies not occurred, but "the additional debt has made PEPCO Holdings more susceptible to event risk (such as the Mirant bankruptcy legislation that currently embroils the company) and has diminished the company's financial flexibility due to restrictive settlement agreements with regulators that were required as a condition for the merger's approval."[21]

These and other events have caused Standard and Poor's to maintain a negative view of mergers. "Utility M&A is like my new puppy dog," Director Peter Rigby says. "When we're walking him in the park he's incredibly seductive—everyone wants to look at him. But the reality is, it's a whole lot harder to take care of this dog than we ever thought, and the outlook is uncertain at best."[22]

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21 *Ibid.*, p. 6.

22 "S&P unsure utility mergers are new trend, but sure they are bad for bondholders," *Electric Utility Week*, June 6, 2005, p. 1.

Utility mergers face different problems than do other types of mergers. While the best merger and acquisition deals boost market value, it is virtually impossible for utility mergers to boost market share because each utility already has 100 percent of customers, Rigby noted. If the regulators require divestiture of assets, then the deal's value is reduced even further.[23] Rigby elaborates on other difficulties associated with utility mergers.

> One, the industry is simply quite different from other industries and what positive generalizations may apply to other industries break down for electric utilities. Second, utility mergers may be even more vulnerable to overestimating the value of synergies in cost savings than other industries, due largely to the regulated nature of the industry. Finally, regulatory risk can undermine the expected value of a large M&A deal.[24]

Utility mergers simply lack the sort of value enhancement potential that exists in other industries. "Merging two electric utilities does not really add a new distribution channel, and utilities really are not creating new products that need new channels anyway. This gets to another problem for the value-enhancing proposition. **Electric utilities by and large are not growing industries for which M&A typically makes sense.**"[25]

S&P highlights the importance of cost savings to utility mergers, given the relatively small potential for an increase in revenue growth rates. However, cost savings may never materialize. Reasons include the up-front costs associated with regulatory approvals—which may stretch over a significant time period—and the failure to adequately factor in other one-time costs—such as employee and lease terminations.

The acquiring company often fails to appreciate the costs of owning a multi-state utility. States do not all support utility credit in the same fashion, and utilities face increased regulatory hurdles in dealing with multiple state regulatory commissions. As Rigby notes, companies such as Entergy and PacifiCorp operate across several states and "constantly face cost allocation and recovery challenges."[26]

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23 *Ibid.*

24 Peter Rigby, "Why U.S. Electric Utility Mergers Jeopardize the Balance Sheet," Standard & Poor's, June 14, 2005.

25 *Ibid.* (emphasis added).

26 *Ibid.*

"Investment bankers have tremendous financial incentives, both individually and collectively as firms, to identify and close deals."

More troubling, the merging companies may not be able to rely on outside interests to carefully scrutinize the deal.

> Finally, in so far as target and acquirer rely upon their investment bankers (those who brought them the deal) to conduct the due diligence concerning cost savings, they may be more vulnerable to disappointment than had they done the work themselves. Investment bankers have tremendous financial incentives, both individually and collectively as firms, to identify and close deals. And they get paid up front regardless of actual long-term performance. Consequently, the potential for biased cost estimates is very real.[27]

This confluence of factors has led S&P to regard utility mergers with some skepticism.

A second ratings agency, Fitch Inc., questions whether utilities will continue to pursue the "back to basics approach," and highlights some of the difficulties with utility mergers. The agency notes that mergers usually produce higher returns for the selling rather than the purchasing company, observing that "Often the buyer winds up overleveraged and exposed to the risk of failure to achieve expected merger benefits, which are counted on to repay acquisition debt."[28] Companies such as Wisconsin Energy Corp., TXU Corp., Progress Energy Inc., PEPCO Holdings Inc., FirstEnergy Corp., and DTE Energy Co. are still carrying acquisition debt that has proven difficult to repay.

Fitch adds that the common flaw in these mergers was senior management's inability to properly foresee the risks associated with mergers. As an alternative to the way that companies currently do business, Fitch advises that corporate directors and senior managers focus on risk management and develop methods to identify risk in their future financial decisions. In particular, they should pay more attention to downside scenarios.

The other major ratings agency, Moody's Investors Service, is the most optimistic about utility mergers.[29] All three ratings agencies, however, have concerns over the acquisition of independent power project ("IPP") companies because these companies carry high debt levels.

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27 *Ibid.*

28 "Back to Basics: A Durable Strategy or a Flash in the Pan?" Fitch Ratings, *Global Power Quarterly,* "June 2004, p. 3.

29 "Rating agencies split on value of mergers in the power sector." *Electric Power Daily,* June 30, 2005, p. 1.

Mismanagement and Merger Failure

Despite the failure of many mergers to provide hoped-for financial rewards and their tendency to harm the merged utility's credit rating, they continue apace. Why do utilities continue to engage in risky behavior? One explanation offers both a reason as to why utilities enter into merger activity and why they fail: mismanagement. There seems to be an assumption that because a company has been successful in one area, those successes will automatically carry over into all of its endeavors. For a variety of reasons, this can be a false assumption.

There seems to be an assumption that because a company has been successful in one area, those successes will automatically carry over into all of its endeavors.

Several factors related to mismanagement contribute to unsuccessful mergers. Among the reasons are poor decision making, CEO hubris, and an inability to adapt to new regulatory structures. Occasionally higher-ups are intentionally deceptive, as Rebecca Smith and John Emshwiller document in the case of Enron.[30]

But not all mismanagement is a result of intentional malfeasance. Sometimes a manager or corporate team bites off more than it can chew, or the organization steps away from what it knows.[31] It would seem that this would be less of a problem in utility mergers, since the two entities should be rather similar in structure and operations, but even then there might be subtle differences that the acquirers do not foresee. For example, the merger of AT&T and NCR—two similar organizations—failed partially because of the combination of disparate corporate cultures. AT&T was unionized, whereas NCR was not. NCR had a "conservative" corporate culture whereas AT&T was more "politically correct."[32] Thus, the two companies did not gel well together.

In addition, the targeted company may feel resentment towards the new management. This dampens morale and increases the turnover rate among the top staff. More importantly, outsiders often fail to grasp the nuances of the acquired business's operations.[33] Further, the acquiring company

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[30] Rebecca Smith and John R. Emshwiller, *24 Days: How Two Wall Street Journal Reporters Uncovered the Lies that Destroyed Faith in Corporate America* (New York: Harper Collins, 2003).

[31] Robert F. Bruner, *Deals from Hell: M&A Lessons that Rise Above the Ashes* (Hoboken: John Wiley and Sons Inc., 2005), p. 39.

[32] *Ibid.*, p. 189.

[33] David J. Ravenscraft and F.M. Scherer, *Mergers, Sell-Offs, and Economic Efficiencies* (Washington: The Brookings Institute, 1987), p. 136.

exacerbates tension by over-emphasizing short-term goals and profit, which gives the appearance that the parent company looks at the acquired company merely as a "cash cow." As a result, the acquiring company scrimps on investment, further harming morale at the acquired company.[34]

The META Group conducted a survey of utility industry CFOs and CIOs to gauge how large investor-owned utilities viewed the effects of mergers and acquisitions on the industry. Almost 90 percent of survey respondents reported that their merger objectives had been only partially achieved or not achieved at all.[35] The report notes that utilities generally do not have the skills or experience necessary to develop plans for large-scale change, and in the new world of deregulation, utilities are even more unprepared than before for mergers and acquisitions:

> Utilities are, historically speaking, not nimble organizations. For decades, success for utilities was defined by consistent and predictable performance in a stable competitive environment. Deregulation and the associated increase in competition requires a different set of competencies, namely the definition and implementation of change initiatives. Successful change requires realistic and rigorous assessment and planning. Survey results suggest that few utilities perform the necessary assessment and planning steps critical to the success of mergers and acquisitions.[36]

Sometimes a company may not have all the needed facts in its possession. In the midst of all the turmoil surrounding Enron in the fall of 2001, Dynegy nearly bought Enron. Dynegy CEO Chuck Watson claimed that his company had done its due diligence on Enron, but then a mere week later Enron released third-quarter SEC reports indicating that its financial situation was far worse than the public—and especially Watson—even knew. Watson was furious, and the merger fell through.[37] But the fact that Dynegy had come so perilously close to making the deal demonstrates that it did not have all the information needed to adequately assess Enron's financial state.

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34 *Ibid.*, p .139.

35 *M&A in the Utility Industry: Strategies for Successful Business Integration, Results from a Survey of CFOs and CIOs*, Executive Summary of the Report of the META Group, 2000, p. 2.

36 *Ibid.*, p. 3.

37 Bruner, p. 302.

In an earlier example, Kansas City Power & Light ("KCPL") terminated its merger with Western Resources (now known as Westar Energy) in January 2000 because of the financial problems of Protection One—a Western Resources subsidiary—and the related decline in Western Resources's stock price. In its letter canceling the agreement, KCPL noted that a key strategic reason for entering into the merger was the expectation of growth from unregulated businesses, including Protection One. The collapse of this expectation suggests that better information about Protection One's prospects may have kept KCPL from agreeing to the merger in the first place.

"Merger makers seriously over-estimated their ability to integrate, motivate, and effectively control the companies they acquired, and as a result they underestimated the costs that came with formal control."

Corporate mismanagement of this type is often attributed to hubris. Several authors have advanced the "hubris hypothesis," speculating that over-confidence is the basis of poor decision-making.[38] This over-confidence blinds decision-makers to potential pitfalls, as they believe that past successes will be replicated without much difficulty, regardless of shifting circumstances. When management finally discovers errors, it is often too late in the process to correct them.

Hubris mixes with "empire-building motives" to blind CEOs to the cost of mergers. "Merger makers seriously over-estimated their ability to integrate, motivate, and effectively control the companies they acquired, and as a result they underestimated the costs that came with formal control."[39]

Whether or not it is because of hubris, a company acquiring a utility in another state can have a difficult time trying to adapt to the form of regulation in the acquired company's home territory. As one industry insider relates, a common refrain from utilities he interviewed was: "We thought our core competency was regulatory management skills. We did not realize it was incredibly local and only related to our state PUC."[40] Michael Hogan, a senior vice president of Centrica North America, also observed the difficulty of transferring regulatory expertise to other jurisdictions. He cited the failure of Public Service Enterprise Group ("PSEG") in the ERCOT region to adapt to Texas's regulations and noted

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[38] *See especially* Ravenscraft and Scherer, p. 212, and Richard Roll, "The Hubris Hypothesis of Corporate Takeovers," 59 *Journal of Business* 197 (1986), pp. 210–13.

[39] Ravenscraft and Scherer, p. 214.

[40] "Will PUHCA Repeal Hasten Utility Consolidations?" in Chadbourne & Parke, LLP, *Project Finance NewsWire*, August 2005, p. 28.

that very few companies "have developed or will develop a platform that allows them to administer those very mundane aspects of operating in multiple regulatory environments."[41]

Board members theoretically could provide a check on a CEO's merger decision, but herein lies another difficulty. Boards are usually not involved in merger negotiations, and senior management often does not consult the board for advice. As a result, the Board's role may extend no further than to rubber-stamp proposed company mergers.[42]

In his analysis of merger pitfalls, Patrick Gaughan concluded that many merger failures are related to lack of effective oversight. He looked at several studies on governance, and found a direct relationship between board independence and effective company governance, as well as an inverse relationship between board size and company efficiency, as companies with a smaller number of board members have higher market values.[43] In short, an independent, reasonably sized board is more likely to provide effective governance.

Board independence is particularly important in regard to mergers and acquisitions, because without effective oversight some CEOs will pursue their own goals—for example empire building or increased compensation—rather than the overall company goal of maximizing shareholder wealth.[44] Managers can realize financial and material awards when they arrange a merger, regardless of whether or not the merger proves to be successful in the long term. In fact, they may receive compensation even when the merger falls through. Good corporate governance can ensure that merger decisions are made based on improving the company's performance, rather than on benefiting management.

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41 *Ibid.*, p. 29.

42 Gretchen Morgenson, "A Merger? Anyone Tell the Board?" *New York Times,* June 26, 2005, p. C1.

43 Patrick Gaughan, *Mergers: What Can Go Wrong and How to Prevent It* (Hoboken: John Wiley and Sons, 2005), pp. 217–224.

44 *Ibid.*, pp. 248-249.

Conclusion

Despite the high costs, credit and regulatory risks, and other problems associated with mergers, no abatement of merger activity is in sight. By way of example, Exelon Corp. and PSEG are seeking approval for a merger that is estimated to incur costs of over $700 million over four years.[45] Regulatory reviews of the merger continue, and Exelon has stated that it will offset costs "by eliminating duplicative functions and selling or divesting some power."[46] But as the above-cited studies have shown, hoped-for benefits seldom emerge, and cost-cutting measures often do not materialize. In the end it will be the ratepayer—and the stockholder—who will pay the price for mergers that never realize their predicted benefits. This is a point that Warren Buffett made to the shareholders of Berkshire Hathaway:

> The sad fact is that most major acquisitions display an egregious imbalance: They are a bonanza for the shareholders of the acquiree; they increase the income and status of the acquirer's management; and they are a honey pot for the investment bankers and other professionals on both sides. But, alas, they usually reduce the wealth of the acquirer's shareholders, often to a substantial extent. That happens because the acquirer typically gives up more intrinsic value than it receives. Do that enough, says John Medlin, the retired head of Wachovia Corp., and "you are running a chain letter in reverse."[47]

The question facing electric utility managements in the next few years is whether they have the fortitude to "break the chain" and not participate in a merger—that may not benefit either their ratepayers or their shareholders—simply to keep up with their electric utility peers.

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[45] Anna Marie Kukec, "Utility merger could cost Exelon $700 million," *Chicago Daily Herald*, June 7, 2005, p. 3 (Business).

[46] *Ibid.*

[47] Warren Buffett, *Letter to the Shareholders of Berkshire Hathaway Inc.*, 1994.

American Public Power Association

2301 M Street, N.W.
Washington, D.C. 20037-1484
202-467-2900; fax: 202-467-2910

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