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The Role of Efficiencies in Merger Analysis in the Energy Industry

I. SUMMARY

As the energy industry enters a period of deregulation, new challenges face the antitrust regulators. The history of heavy regulation in the industry has created a situation where there is no history of what a competitive market looks like. Many large firms in the energy sector did not achieve their large size through efficient business practices. The large size was achieved by favorable governmental regulation.

Mergers present an effective solution to the problems presented by the new deregulation. The regulatory agencies must apply industry-specific standards to their review of these mergers. The energy industry presents a unique challenge where concentration and market size do not play as important of a role as they do in other industries. Many larger firms, particularly in electricity generation, operate more efficiently than smaller firms. The creation of these larger firms should not be subject to the same antitrust policy restrictive to concentration that other industries are subjected to.

The merger regulations in the energy industry should focus on the efficiencies created as a result of the merger. Larger firms have been found to operate more efficiently, and increase in market concentration should not be immediately condemned. The most effective tool in the merger approval process is an analysis of the efficiencies created by the merger. The history of regulation has allowed many inefficient firms in the energy industry to survive due to favorable regulation. These firms should no longer be protected. Mergers can create valuable efficiencies through economies of scope which cannot be achieved in their absence.

The situation facing the energy industry also causes the regulatory agencies to institute a different merger policy. The Federal Energy Regulatory Commission retains some of the authority to regulate these mergers. However, their authority is not absolute, as the Federal Trade Commission also possesses some authority. Mergers in the energy industry are unlike mergers in other industries, and this requires the regulatory agencies to make their analysis energy-specific. The Federal Energy Regulatory Commission has superior knowledge of the energy industry, and it devotes its regulation solely to the industry. This focus places it in a superior position to evaluate mergers in the energy industry. The Federal Energy Regulatory Commission should have sole authority to review mergers in the energy industry.

II. INTRODUCTION

Mergers represent an important development in the newly deregulated energy industry. The history of heavy regulation in public utilities and other sectors of the energy industry is changing to become a more competitive marketplace. This change is difficult, as reliable economic models of what a competitive energy market would look like do not exist due to the previous regulation.

The use of efficiencies in merger analysis is gaining increased importance in the newly deregulated industry. In areas such as public utilities, larger firms have been found to operate more efficiently. Using this industry realization in the analysis would push the focus away from concentration and market power as the determinative factor in merger approval and toward efficiencies. Antitrust regulation is to be undertaken for the public

benefit, and therefore, public welfare should be the most important consideration in a merger evaluation. The creation of efficiencies by a merger contributes to the public welfare by creating lower costs for consumers of energy, and therefore, efficiencies must remain an integral part of the analysis.

Mergers in the energy industry are further complicated by the regulatory process. The Federal Trade Commission (FTC) and the Department of Justice (DOJ) do not have the sole authority to regulate energy mergers, as they do in mergers in other industries. The Federal Energy Regulatory Commission (FERC) is also given the authority to regulate mergers because of the agency's superior knowledge of the industry. The FERC's authority is not absolute, however, as the FTC retains some power to regulate these mergers as well. This complicated system of dual authority creates additional challenges in the regulatory process.

III. History of Antitrust Regulation in the Energy Industry

Antitrust doctrine relies upon the utilization of economic theory at a level unmatched in other areas of economic regulation[1]. Economic analysis plays a vital role in many areas of antitrust practice, but particularly in the analysis of the costs and benefits of a merger[2]. The basic purpose of antitrust law is to protect competition, and, by doing so, to increase the welfare of, and ensure fairness to consumers[3].

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[1] William E. Kovacic, *The Modern Evolution of U.S. Competition Policy Enforcement Norms*, 71 Antitrust L.J. 377, 401 (2003)
[2] *Id.*
[3] Ray S. Bolze, John C. Peirce, and Linda L. Walsh, *Antitrust Law Regulation: A New Focus for a Competitive Energy Industry*, 21 Energy L.J. 79 (2000)

A study of antitrust regulation in the energy industry would serve as an excellent proxy for a study of antitrust in all industries[4]. The petroleum industry has spent more time as the focal point of antitrust regulation than any other industry since the passage of the Sherman Act in 1890. Other sectors of the energy industry have also been subject to heavy antitrust regulation[5].

Congress decided against allowing market forces to be determinative in the electric and natural gas industries[6]. Electric transmission service and natural gas transportation were generally perceived as natural monopolies, as one supplier was believed to be able to provide more efficient service. Additionally, the vital role these industries provide to the economy as a whole necessitated reliable service as being consistent with the public interest[7]. Consequently, in earlier days, the electric and natural gas industries were dominated by heavily regulated vertically integrated public utilities[8]. However, as deregulation of these industries is increasing, the antitrust laws are rapidly gaining importance[9].

The Justice Department's case against Standard Oil which brought down John D. Rockefeller's empire in 1911 established the rule of reason as the primary method of antitrust analysis and enforcement[10]. The rule of reason remains the standard upon which mergers in the energy industry are judged to this day[11].

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[4] Kovacic at 443
[5] *Id.*
[6] Bolze et al. at 79-80
[7] *Id.* at 80
[8] *Id.*
[9] *Id.* at 79
[10] Kovacic at 443
[11] Paul Rogers, *The Limited Case For an Efficiency Defense in Horizontal Mergers*, 58 Tul. L. Rev. 503, 512 (1983)

The Federal Trade Commission took several steps in the 1960s and 1970s which were designed to establish the Commission as the principal federal agency for regulation of petroleum industry matters[12]. Legislative regulation of the petroleum industry increased in the 1970s, as antitrust legislation included enactments attempting to divest large firms of ownership of non-petroleum energy sources such as cola and to limit purchases of businesses outside of the energy sector[13].

The major oil companies operated under close scrutiny of Congress and antitrust enforcement agencies in the 1980s[14]. The Federal Trade Commission opposed Mobil's effort to acquire Marathon Oil, and the Commission blocked Gulf Oil's efforts to acquire Cities Service. Later in the decade, however, the FTC approved a number of oil mergers, such as the Texaco-Getty and Chevron-Gulf mergers, subject to a type of divestiture which would become common in later decades[15].

In the 1990s, the attitude toward mergers became much more permissive, as the Federal Trade Commission allowed British Petroleum to purchase Amoco and BP Amoco to purchase Arco. These mergers would most likely not have even been attempted in previous decades, as the FTC's more permissive attitude in the 1980s carried into the next decade[16].

The mergers of the 1990s were made possible due to multiple changes in enforcement policy which came about during the previous decade[17]. One major change was the growing acceptance of taking efficiencies into account in the application of merger rules.

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[12] Kovacic at 443
[13] *Id.*
[14] *Id.* at 444
[15] *Id.*
[16] *Id.* at 442
[17] *Id.* at 444

The increased use of efficiencies in the analysis was an important factor in the willingness of antitrust agencies to specify competitive concerns and allow for remedies, such as required divestiture of certain assets, which fell short of outright prohibition[18].

Antitrust regulation in the energy industry was further complicated by the creation of The Federal Energy Regulatory Commission (FERC) in 1977 as an independent regulatory commission[19]. FERC was given broad authority in the regulation of mergers relating to power and gas companies, but their authority is not autonomous, as other regulatory agencies also retain power to regulate these mergers. FERC presently shares the power to review mergers in the energy industry with the FTC[20].

IV. The Use of Efficiencies in Antitrust Regulation

The analysis of mergers deals with the long-term structure of a market[21]. In recent years, the regulatory agencies have began a more varied analysis, moving away from a strict emphasis on market share and moving toward an analysis which evaluates the market as a whole[22].

Efficiencies resulting from a merger can arise from a variety of sources[23]. In general, operating efficiencies such as those derived from economies of scale, resource allocation and technological innovation vary greatly depending upon how closely related the

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[18] *Id.*

[19] Suzy E. Rosov, Federal Courts do the Two-Step While Texas Dances to a Different Tune: Judicial Review of Agency Rulemaking, 2 Tex. Tech. J. Tex. Admin. L. 299 (2001)

[20] *Id.*

[21] John Burrit McArthur, Anti-Trust in the New [De]Regulated Natural Gas Industry, 18 Energy L.J. 1, 75 (1997)

[22] *Id.*

[23] Alan A. Fisher and Robert H. Lande, *Efficiency Considerations in Merger Enforcement*, 71 Cal. L. Rev. 1580, 1599 (1983)

merging firms' products and processes of production and distribution are[24]. Therefore, operating efficiencies may result from both horizontal and vertical mergers, but they are more likely to result from vertical mergers[25].

Operational efficiencies are the most obvious benefits of a merger. These efficiencies will result from mergers in one of two ways: either the duplication of the efficiencies from one firm to the other or synergistic interactions. These efficiencies may manifest themselves after the merger in one of a variety of ways, such as lower costs to produce the same product, an improvement in the quality of the product that is being produced, or a combination of improvements in cost and quality[26].

A horizontal merger may allow the newly formed entity to achieve economies of scale, but the merger does not create this situation by itself. Therefore, horizontal mergers which cite achieving scale economies as their primary motivation are suspect, except in a new industry or one undergoing rapid technological change which favors larger firms[27]. Vertical efficiencies, on the other hand, would allow the newly formed entity to combine many distribution and marketing costs and increase efficiencies through the benefits of economies of scope[28].

In the evaluation of the creation of efficiencies in a merger, the focus is placed on the relationship between cost savings and market structure. Mergers frequently allow for a quick way to gain a larger market share. Several recent studies, however, have shown that large firms have a tendency to be more efficient in a market. Some believe that these

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[24] *Id.*
[25] *Id.*
[26] *Id.*
[27] *Id.*
[28] Richard D. Cudahy, The FERC's Policy on Electric Mergers: A Bit of Perspective, 18 Energy L.J. 113, 132 (1997)

studies demonstrate that mergers will increase the overall efficiency of firms in a given market[29].

However, this is not always the case. Many mergers do create efficiencies, but many mergers increase costs[30]. Smaller firms benefit the most from mergers, as many efficiencies are only present once a firm has reached a sufficient size[31]. Not all mergers, however, result in an increase in efficiencies, some result in higher overall costs[32].

The agencies' tendency to reject efficiency claims does not represent an inherent hostility to the efficiency defense[33]. The infrequent acceptance of efficiency claims reflects the skepticism among the enforcement agencies to efficiency claims which results from the large number of specious efficiency claims that have been presented by merging firms. The result of this tendency of illegitimate efficiency claims has resulted in even reasonable efficiency claims being greeted with a skeptical view by the enforcing agencies[34].

The 1997 Merger Guidelines enact a three prong test to determine if an efficiency argument will impact a merger review decision[35]. For the efficiency to impact the merger review, the efficiency must be: (1) analytically valid; (2) verified; and (3) specific to the merger in question. For the efficiency in question to satisfy the Merger Guidelines' test, it must satisfy all three prongs of this test[36]. Failure to meet any of the three tests will

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[29] Fisher and Lande at 1605
[30] *Id.*
[31] *Id.* at 1606
[32] *Id.* at 1603-1604
[33] Joseph Kattan, The Role of Efficiency Considerations in the Federal Trade Commission's Antitrust Analysis, 64 Antitrust L.J. 613, 618 (1996)
[34] *Id.*
[35] Malcolm B. Coate, *Efficiencies Merger Analysis: An Institutionalist View*, 13 Sup. Ct. Econ. Rev. 189, 193 (2005)
[36] *Id.*

cause the efficiency argument to fail. Once the efficiency is deemed cognizable, the analysis then balances the efficiency against any anticompetitive effect of the merger[37].

The efficiency must not be causally related to a specific reduction in quality in order to be valid. Output reductions, by their very nature, reduce the total cost, but this total cost reduction would not be classified as an efficiency[38]. Anticompetitive behavior post-merger would allow the firm to reduce its spending on labor, materials and services, and this reduction would not be classified as a beneficial efficiency[39].

After it has been established that the efficiencies are at least partially analytically valid, it is necessary to substantiate the cost savings. This process requires the regulatory agencies to verify the likelihood and magnitude of the cost savings resulting from the efficiencies[40]. The Guidelines place the burden on the parties to provide to the enforcement agencies' internal information which will demonstrate the likelihood and magnitude of the efficiencies. The Guidelines do not limit the efficiency presentation to direct monetary savings, so transaction cost economies are given weight. Transaction cost efficiencies may demonstrate the firm's belief that the merger will allow it to compete more aggressively in the future[41]. Weight is given to enhancements to competition which influence market performance[42].

Efficiency merger analysis requires the efficiencies to be specific to the transaction at issue. The standard requiring the efficiency to be specific to the merger must be judged against whether or not the efficiencies are practical in the business situation[43]. The

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[37] *Id.*
[38] *Id.*
[39] *Id.* at 194
[40] *Id.* at 195
[41] *Id.*
[42] *Id.* at 196
[43] *Id.*

requirement that the proffered efficiencies must be demonstrated as merger-specific in advance benefits competition by preventing approval of mergers in which stated efficiencies do not result from the matter at hand, the merger approval[44]. Without the merger-specific requirement, an anticompetitive transaction would be excused on the basis of efficiencies in a merger which was harmful to competition. However, the requirement that efficiencies must be merger-specific does have a negative effect, in that the burden of proof to merging parties is more difficult for parties whose mergers have legitimate efficiencies and do not allow mergers whose efficiencies are difficult to quantify in advance[45].

Proving that the efficiencies are valid and specific to the merger are not the sole requirements of merging parties. The regulatory agencies require the cost savings which result from an anticompetitive merger transaction to benefit the consumers in the form of lower prices[46].

Mergers often bring about efficiencies through synergies, but these efficiencies are difficult to specifically quantify in advance of the merger. Absent specific quantitative evidence of these efficiencies before the merger, the efficiencies will be disregarded by the regulatory agencies altogether[47]. Therefore, many efficiencies do not lend themselves to the verification process required by the antitrust regulatory agencies under the Merger Guidelines[48].

Proof that the efficiencies at issue cannot be achieved through means less restrictive to competition than the merger is required by the Merger Guidelines. The merging

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[44] Kattan at 619
[45] *Id.*
[46] *Id.*
[47] *Id.* at 618
[48] *Id.* at 619

parties must submit exacting proof that the efficiencies resulting from the merger are specific to the merger and not due to alternate market situations. This rigorous standard prevents many efficiencies from being recognized[49].

After establishing that the efficiencies are both analytically valid and specific to the merger at issue, the Guidelines state that the reviewing agency must consider whether the efficiencies are sufficient enough to counteract the anticompetitive effects resulting from the merger[50]. As the competitive concerns from the merger increase, the magnitude of the efficiencies resulting from the merger must increase as well[51]. Efficiencies are almost never thought to be a justification for a merger which would create a monopoly or near monopoly. The Guidelines do not offer much guidance in the mechanics of making the marginal decision in this case, and therefore, the analysis relies on economic evidence in order to make the ultimate decision[52]. The energy industry further complicates this process, as mergers involving public utilities require a balancing of the public interest in the availability of reasonably priced energy supply against the potential anticompetitive effects of the proposed action[53].

Courts face additional difficulties in addressing efficiency issues on top of the process required by the regulatory agencies[54]. Only large efficiencies matter in a court proceeding, but the cross examination of the firms' proffered efficiencies generally cause very large projections to be discredited. Efficiencies do not generally appear relevant when subjected to the strict standard of a contentious courtroom proceeding[55].

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[49] *Id.* at 618
[50] Coate at 197
[51] *Id.* at 198
[52] *Id.*
[53] Alabama Power Co. v. FPC, 511 F.2d 383 (D.C.Cir.1974)
[54] Coate at 228
[55] *Id.* at 231

Mergers reduce the number of competitors in the market, and this leads the regulatory agencies to initially view them as anticompetitive[56]. However, the showing of demonstrable efficiencies created as a result of the merger will rebut this initial presumption, and, after the showing of created efficiencies, the merger will be analyzed under the rule of reason approach, not per se condemnation[57]. Merger-engendered efficiencies are therefore analyzed under the rule of reason analysis to determine if the pro-competitive benefits derived from the mergers benefit the public interest[58].

The onset of deregulation often creates a turbulent upheaval for the industry being deregulated. Deregulation pushes an industry towards a new competitive equilibrium, but difficulties are faced along the way[59]. When a capital-intensive industry is deregulated, market concentration invariably rises[60]. Merger is the primary mechanism through which industry concentration is increased[61].

This is the situation presently facing the public utility industry. This capital-intensive industry is being deregulated and competitive forces are taking over. The transition is turbulent, as it is in all deregulated industries.

Welfare Considerations

The primary duty of antirust regulation is to classify profit-maximizing behavior with respect to that behavior's impact upon consumer welfare[62]. Antirust regulation deals with scenarios in which a business attempts to increase its profits through achieving

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[56] Rogers at 512
[57] *Id.*
[58] *Id.* at 547
[59] Cudahy at 119
[60] *Id.* at 119-120
[61] *Id.* at 120
[62] Gary Taylor, Romkaew Broehm and James Bohn, *Competition in Wholesale Electric Power Markets*, 23 Energy L.J. 281, 290 (2002)

a new efficiency in its business model, by gaining monopoly power and restricting output, or by a device not attributable to allocative efficiency. The task of antitrust regulation is to target and prohibit those business decisions which do not benefit consumer welfare, making efficiency-enhancing business decisions the only allowable method to increase profits[63].

There is no clear and reliable method for analyzing when a business decision will increase efficiency[64]. Therefore, antitrust analysis must first focus on the elimination of mergers which clearly do not increase efficiencies in the post-merger entity created. The questioned practice must be evaluated to determine if it will restrict output. If so, the practice will be held lawful only if it can demonstrate with reasonable certainty that the merger will create efficiency enhancing results[65].

A large business size due to internal growth demonstrates efficiency, but when a large business size is achieved solely through a proposed merger, the evidence of gained efficiencies is not clear. If a merger creates a more concentrated market in which a firm can use market power, the increased size of the business is not a result of a more efficient allocation of resources[66].

There is no reason to assume that the merger of two businesses benefits social welfare and the public interest. Therefore, social policy should be strictly applied to mergers, and mergers which generate an increase in market concentration (and allow for one firm to be able to exercise market power) should be prohibited[67].

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[63] *Id.*
[64] *Id.* at 291
[65] *Id.*
[66] Natl. Union Elec. Corp. v. Emerson Elec. Co., 1981 WL 2132, 5 (N.D.Ill.)
[67] *Id.*

Consumer welfare is maximized when economic resources are allocated to their best use in order to provide consumers with an assured competitive price and quality[68]. For that reason, the antitrust laws are only concerned with acts that harm allocative efficiency, thereby raising the price of goods above their competitive level or diminishing their quality[69].

Efficiency analysis of mergers should focus on the benefits to consumer welfare from the merger. These standards are strictly applied, as there is no inherent advantage to consumer welfare in a merger. The main focus of antitrust analysis in a merger is consumer welfare, and only those mergers which provide a net benefit to consumer welfare will be approved.

Burden of Proof When Efficiencies Are Claimed

The new developments in antitrust regulation understand the importance of efficiencies in the merger approval determination, and the regulatory authorities use an analysis of efficiencies to ensure that only anticompetitive mergers are enjoined[70]. In the analysis, efficiencies represent an increase in the aggregate production of the economy in a manner which benefits consumer welfare[71]. Efficiencies derived solely from the newly created post-merger entity's increased bargaining power as a result of the merger do not qualify as efficiencies in the merger analysis. Only efficiencies which result in a net gain

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[68] Pool Water Products v. Olin Corp., 258 F.3d 1024, 1034 (9th Cir.2001)
[69] *Id.*
[70] Coate at 189
[71] *Id.* at 190

to the productive capacity of the economy as a whole are considered in the analysis to counteract any anticompetitive effects of the merger[72].

If a merger is deemed likely to be anticompetitive, the merging parties must demonstrate that the merger will benefit consumer welfare for the merger to be approved[73]. A merger which inhibits competition is presumptively deemed to be illegal[74]. The burden of proof is therefore shifted to the merging parties to demonstrate that the merger will benefit consumer welfare by creating efficiencies[75]. The merging parties are faced with the burden of proof to show both that the merger would create efficiencies which could not be achieved through other methods which are less restrictive to competition and that the anticompetitive effects of the merger are outweighed by the pro-competitive benefits of the created efficiencies. The burden is on the party claiming that efficiencies will be created by the merger to show these efficiencies[76].

V. The Roles of the Federal Regulatory Agencies

The Federal Energy Regulatory Commission was created in 1977 as an independent regulatory commission operating under the authority of the Department of Energy[77]. FERC was given a wide variety of powers, including broad authority in the regulation of mergers and acquisitions relating to power and gas companies[78]. While the FERC has

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[72] *Id.* at 191
[73] James Cooper, Luke Froeb, Daniel O'Brien and Michael Vitta, *A Critique of Professor Church's Report on the Impact of Vertical and Conglomerate Mergers on Competition*, 1 J. Competition L. & Econ. 785, 794 (2005)
[74] Alan J. Meese, Antitrust Balancing in a (Near) Coasean World: The Case of Franchise Tying Contracts, 95 Mich. L. Rev. 111, 123 (1996)
[75] James Cooper et al at 794
[76] *Id.* at 124
[77] Rosov at 301
[78] *Id.*

clear regulatory authority over mergers in the energy industry, the Commission cannot solve all regulatory disputes on its own[79].

FERC and the FTC engage in similar methods of merger analysis. If the initial analysis indicates possible anticompetitive effects, the agencies will undertake further analysis in order to formulate a detailed market analysis[80]. If the analysis indicates that a collaboration has had, or is likely to have, anticompetitive effects, the agencies begin an analysis of whether or not the agreement is reasonably necessary in order to achieve cognizable efficiencies[81]. The agency's decision about challenging the proposed merger is then made, based upon the balance of the intended competitive harm and the efficiencies which will result from the merger. The greater the resulting competitive harms, the greater the magnitude of efficiencies directly resulting from the merger required in order for the Commission to approve the proposed merger[82].

FERC and the antitrust agencies are charged with the task of predicting when a proposed merger is likely to reduce competition in the relevant market[83]. The economic analysis used in this process has not yet advanced to the point where a prediction can be made with reasonable certainty, and pre-approval is particularly difficult in the public utility industry because such a heavily regulated industry creates difficulties in defining the relevant market[84]. The Guidelines are even more difficult to apply in the electricity

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[79] Jim Rossi, *Moving Public Law Out of the Deference Trap in Regulated Industries*, 40 Wake Forest L. Rev. 617, 668 (2005)
[80] Submitted Reports, *Report of the Antitrust Committee*, 22 Energy L.J. 143, 152 (2001)
[81] *Id.* at 153
[82] *Id.*
[83] Submitted Reports, *Report of the Committee on Electric Utility Regulation*, 15 Energy L.J. 505, 524 (1994)
[84] Robert J. Michaels, *Market Power in Electric Utility Mergers: Access, Energy, and the Guidelines*, 17 Energy L.J. 401, 424 (1996)

industry because of the rapidly expanding technology associated with the industry, making it even more difficult to predict the effects on the relevant market[85].

FERC's authority to regulate mergers in the energy industry is set forth in Section 203 of the Federal Power Act, 16 U.S.C. §824b(a), which states that the Commission shall approve of a merger in the energy industry if, after notice and allowing for the opportunity for a hearing, it is found that the proposed transaction is consistent with the public interest[86]. Section 203 of the Federal Power Act prohibits public utilities from disposing of its facilities (either by selling, leasing or otherwise) without first receiving the authorization of the Commission to do so[87]. FERC's decision-making process is based solely on whether or not the transaction is consistent with the public interest[88]. FERC attempts to maintain neutrality between encouraging and discouraging mergers[89].

FERC has adopted the guidelines of the other federal regulatory agencies in reviewing mergers. The current FERC merger policy has limited FERC's review of a merger, and that merger's effect on competition has become the most critical factor in the FERC determination[90].

Under the guidelines set forth in Section 203 of the Federal Power Act, the FERC may approve mergers in the energy industry only if it will be consistent with the public interest[91]. Public interest includes both preserving economic competition in accordance with antitrust laws and the policies of energy regulation already in place. The most

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[85] *Id.*
[86] Lawrence J. Spiwak, *Expanding the FERC's Jurisdiction to Review Utility Mergers*, 14 Energy L.J. 385, 395 (1993)
[87] Milton A. Marquis, DOJ, FTC and FERC Electric Power Merger Enforcement: Are there too Many Cooks in the Merger Review Kitchen?, 33 Loy. U. Chi. L.J. 783, 784 (2002)
[88] *Id.*
[89] Cudahy at 118
[90] Marquis at 784
[91] *Wabash Valley Power Ass'n, Inc. v. FERC*, 268 F.3d 1105, 1115 (D.C.Cir.2001)

important public interest reflected in energy regulation is to encourage the development and distribution of a plentiful supply of electricity and natural gas at a reasonable price, due to those commodities overall value and importance to society[92].

FERC's guidelines for merger analysis set out five steps: (1) assess whether the merger would significantly increase concentration; (2) assess whether the merger could result in adverse competitive effects; (3) assess whether entry could mitigate the adverse effects of the merger; (4) assess whether the merger results in efficiency gains not achievable by other means; and (5) assess whether, absent the merger, either party would likely fail, causing its assets to exit the market[93].

The Commission has a formal review process with well specified filing requirements and guidelines for corporate applications[94]. Before filing a merger application with the FERC staff, merging parties may seek a pre-filing conference[95]. This allows applicants an opportunity to discuss the proposed transaction with FERC staff on an informal basis. This is the only opportunity the parties have to have informal discussions with FERC[96].

In FERC's analysis of identifying potential anticompetitive effects, the Commission relies heavily on third-party interventions. All information received by the Commission from the merging parties themselves and intervening third parties forms the public record in the case[97].

After the deadline for intervenors has passed, the FERC conducts an internal review of the merger. In addition to the FERC review of the merger, the FTC applies scrutiny to

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[92] *Id.*
[93] Cudahy at 117
[94] William H. Hieronymus, J. Stephen Henderson and Carolyn A. Berry, *Market Power Analysis of the Electricity Generation Sector*, 23 Energy L.J. 1, 19 (2002)
[95] *Id.* at 19-20
[96] *Id.* at 20
[97] *Id.*

electric mergers[98]. Unlike the FERC process, the FTC review process takes place informally and behind closed doors. Third parties are allowed to intervene to make their concerns known, and the concerns of competitors and intervenors are an important part of the decision-making process, as it is in the FERC review process[99].

Antitrust merger analysis in the energy industry is in a unique position due to the authority to review the mergers being vested in both FERC and the FTC. This dual authority structures provides unique benefits and challenges for the energy industry.

FERC unquestionably has superior knowledge of the power industry when compared to the FTC by virtue of its oversight of all aspects of the energy industry[100]. Supporters of FERC authority in merger analysis point to this increased familiarity with the evaluation of power markets and the similarity of that review process with the merger review process. The reviewing standard used requiring the merger to be beneficial to the public interest for approval is more appropriate in an industry which is in a transition period away from heavy regulation towards deregulation. General antitrust standards, as applied by the FTC, focus on the impact on the measure of competition is better suited to industries which do not have a history of heavily regulated monopolies[101].

Critics of the FERC merger review state that the FERC does not have the necessary expertise to review mergers, as FERC is not an antitrust agency[102]. Investigating the competitive effects of a proposed merger requires a vastly different skill set then the setting of rates and other FERC responsibilities. The antitrust agencies review mergers in

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[98] *Id.*
[99] *Id.* at 21
[100] Marquis at 787
[101] *Id.*
[102] *Id.* at 788

all sectors of the economy, and they can compensate for their lack of energy-specific expertise by consulting with FERC staff about the specifics of the energy industry[103].

VI. Efficiencies in the Energy Industry

For over a hundred years, the electricity industry in the United States consisted of vertically-integrated investor-owned utilities[104]. These utilities, however, were heavily regulated at both the state and federal levels. The regulation of this industry was fueled by the belief that economies of scale would benefit this industry while competition would not serve the best interests of consumers[105].

Many analysts, however, have long believed that the antitrust analysis applied to this industry erred in its belief that heavily regulated monopolies were the best solution for consumers[106]. These analysts contend that the industry was unnecessarily fragmented and consolidation would result in increased efficiency in the market. The industry has not traditionally adopted the views of these analysts, as the requirement of merger approval by multiple state and federal agencies has made it hostile to mergers and acquisitions [107].

The market has undergone a rapid change recently, as FERC and other agencies have become more receptive to efficiency-enhancing mergers. The utilities themselves are adjusting as they prepare for the change in the market from a heavily regulated monopoly

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[103] *Id.*
[104] Richard J. Pierce, *Antitrust Policy in the New Electricity Industry*, 17 Energy L.J. 29 (1996)
[105] *Id.*
[106] *Id.*
[107] *Id.*

to vigorous competition[108]. Inefficient firms will not survive in the changing marketplace, as they will be acquired by, or driven out of business by, more efficient competitors as the protection of heavy regulation is no longer there. This newfound competition also must alter the way regulatory agencies view the industry[109].

FERC has found that obtaining an affiliate by a public utility may harm competition in electricity markets by raising entry barriers, increasing market power and impeding market efficiency[110]. This anticompetitive harm may not be able to be remedied merely by FERC's rate regulation, and therefore, FERC is required to regulate the merger itself[111].

Not all energy mergers which in some ways inhibit competition are necessarily a negative for consumers[112]. Energy mergers may benefit consumers by lowering costs. Three categories of efficiencies may result from these otherwise anticompetitive mergers: (1) combining complementary skills; (2) more efficient allocation of risk; and (3) reducing costs related to financing[113]. On the other hand, energy mergers may harm consumers by increasing market share of the newly merged entity and therefore encouraging the newly merged entity to exercise market power[114].

In cases where the harm to competition is clear, the merger application will be denied unless a fuller inquiry is justified by the presence of considerable efficiencies resulting

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[108] *Id.* at 30
[109] *Id.*
[110] Submitted Reports, *Report of the Antitrust Committee*, 26 Energy L.J. 521, 533 (2005)
[111] *Id.*
[112] *Id.* at 539
[113] *Id.* at 541
[114] *Id.*

from the proposed transaction[115]. Unless a merger deemed inherently suspect is supported by the creation of significant efficiencies from the merger, it will be denied[116].

Utility mergers will produce efficiencies when they take advantage of technological advancements[117]. Therefore, horizontal mergers between two firms which specialize in one stage of production will not create the same level of cognizable efficiencies that other types of utility mergers will. These mergers merely duplicate the processes already used, they cannot generate efficiencies through economies of scope[118]. Efficiency gains, however, will result from a merger in which the vertical reach of the merging firms will expand post-merger to increase the scale of production[119]. Mergers which do not exploit the potential vertical efficiencies do not result in the level of cognizable efficiencies after the merger[120].

Regulators must assess efficiency claims brought forth by merger analysts are predicted to result from vertical or horizontal consolidation in the post-merger entity[121]. Efficiency gains from vertical consolidations are more plausible, and these efficiency claims should be given more weight[122].

After a few years of compiling data in a competitive electric utilities industry, FERC will acquire the necessary knowledge to determine the significance of capacity constraints. Until such data has been adequately compiled, FERC should focus its merger policy on the smallest possible market definition and as generally hostile to

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[115] Kattan at 624
[116] *Id.* at 625
[117] Raymond S. Hartman, The Efficiency Effects of Utility Mergers: Lessons From Statistical Cost Analysis, 17 Energy L.J. 425, 431 (1996)
[118] *Id.* at 431-432
[119] *Id.* at 432
[120] *Id.* at 433
[121] *Id.* at 451-452
[122] *Id.* at 452

mergers[123]. FERC should not initially designate the market as large, and it should not be generally in favor of mergers. If the data after a few years of studying the newly competitive industry reveals that the market definition was smaller than was previously thought, it would be difficult to undo the mergers which had already been approved[124]. This would create additional problems for FERC as it attempted to undo the mergers it had approved[125].

These conservative merger policies are only interim policies[126]. Evidence that the relevant markets were larger than originally thought, evidence that concentrated electric utilities markets do not make the exercise of market power easy or likely, and evidence that the economies of scale were larger than originally thought would all cause a change in this conservative merger policy[127]. If any of those conditions developed in the market, FERC's merger policy would change and it would become more receptive to mergers[128].

FERC is not limited to merely approving or disapproving an energy merger. FERC may consider structural remedies when making the decision to approve a merger such as: (1) requiring transmission upgrades to force the newly merged entity to expand its geographic market's scope; (2) eliminating entry barriers in the market; (3) divestiture of certain assets; (4) encouraging price-responsive demand by requiring more efficient price structuring[129].

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[123] Pierce at 47
[124] *Id.* at 47-48
[125] *Id.* at 48
[126] *Id.* at 56
[127] *Id.* at 56-57
[128] *Id.* at 57
[129] *Report of the Antitrust Committee* at 536

The primary goal of antitrust policy is to benefit the public, not merely to refrain from doing harm[130]. Proof of valid efficiencies is therefore required before the burden shifts to the party challenging the merger because of its anticompetitive effects[131].

The natural gas industry has been too regulated for too long for any reliable market analysis to be made presently[132]. However, given the economies of scale present in the industry, larger companies may be able to form the competition envisioned by Congress and FERC[133].

VII. Benefits Achieved in Energy Mergers

The increase in market concentration which results from a merger begins suspicion that mergers are anticompetitive[134]. However, the economies of scope which result from a merger may produce pro-competitive benefits to consumers, especially in the nature of efficiencies resulting from the merger. Merging firms which serve complementary classes of competitors, and therefore are not competitors, are more likely to result in creating the necessary types of efficiencies which would allow the merger to be approved[135].

Mergers can also reduce both the cost of capital and the risk to the business itself[136]. These efficiencies associated with mergers are especially common in industries which are very capital-intensive, as a firm in a capital-intensive industry needs to assume a greater

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[130] Kattan at 626
[131] Kattan at 628
[132] McArthur at 75
[133] *Id.* at 76
[134] Cudahy at 131
[135] *Id.*
[136] *Id.* at 132

financial risk in order to build the necessary infrastructure to compete in its market. A merger would allow the larger newly formed entity to better be able to assume the necessary risk to make the capital improvements[137]. These same benefits could be assumed by a merger of firms in different regions; as such a merger could increase the size and diversity of the firms, thereby allowing for a greater investment in capital and a lower magnitude of assumed risk, without increasing concentration in the market[138].

Excess capacity is the most difficult issue in electricity generation, but mergers help to alleviate some of the risk and trouble associated with excess capacity. The utilities will be reluctant to assume the risk of expanding their operation to include excess capacity unless there is a strong likelihood that expansion will result in increased profitability. Consumers, however, have an interest in the maintenance of adequate capacity[139]. Electric utilities must maintain a balance of assuming this risk in order to maintain adequate capacity[140]. Only those firms which have the resources to assume this risk can adequately prepare for the exigencies of needing excess capacity[141].

VIII. CONCLUSION

Efficiencies should be given greater weight in merger analysis in the energy industry. The history of regulation of the industry has deprived regulators of the knowledge of what a truly efficient industry would look like. Because of this, merger policy must be cautious as the industry begins deregulation.

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[137] *Id.*
[138] *Id.* at 133
[139] *Id.*
[140] *Id.* at 133-134
[141] *Id.* at 134

Numerous studies have shown that larger firms, particularly in the public utilities sector, operate more efficiently than smaller firms. Concentration and market power should not hold the same importance in antitrust analysis in the energy industry. Efficiencies play a much larger role. Merger analysis should not be as distrustful to energy mergers which create a higher level of concentration in the market. More attention should be given to the role of efficiencies which will be created by the transaction. The shift to a deregulated industry will cause unforeseen challenges which the antitrust regulatory agencies must devise new solutions to handle.

The regulatory authorities must focus their merger analysis on the role of efficiencies. Efficiencies increase consumer welfare, and this meets FERC's standard of approving transactions which are consistent with the public interest. Efficiencies must be the main focus of the regulatory agencies in merger analysis for the industry to thrive in deregulation.

The convoluted system of dual regulatory authority for mergers in the energy industry must be streamlined. FERC has far greater knowledge of the energy industry, and, because of this expertise, the authority to regulate mergers in the energy industry should be given to FERC. Although the FTC has more knowledge of antitrust issues generally, FERC's superior knowledge of the industry provides more benefits in this analysis. Mergers in the energy industry are unlike mergers in other industries, and the process used in the approval determination must also be different. FERC's focus on the sector would allow the agency to devise a merger policy which would be specific to the industry and its unique challenges. This industry-specific standard must rely more on efficiency calculations and less on concentration and market power statistics. The FTC's

determination is necessary in many industries, but their merger approval methodology would not solve the problems of the deregulated energy industry. FERC is charged to act for the public benefit, and this standard would allow FERC to make greater use of efficiencies in merger analysis.

The deregulation presently taking place in the energy industry presents new challenges both to the industry and to antitrust regulation as a whole. The regulatory agencies must adapt to this new development by placing more regulatory authority in FERC and by using efficiencies to a greater degree in the merger review process.