Viewpoint

Edward J. Mitchell

New Ideas about Oil Mergers

IT WOULD HAVE BEEN surprising if the recently announced oil company mergers—Standard Oil of California with Gulf, Texaco with Getty, and Mobil with Superior—had not provoked attacks against Big Oil. However, it is a tribute to the increased sophistication of policy discussions that, this time, the attacks did not focus exclusively or even mainly on the issue of monopoly and concentration. The few witnesses who cried monopoly before the congressional committees that reviewed these mergers were largely ignored, even by usually receptive congressmen. For it is well known by now that, while oil companies are big, the market they serve is much bigger and is, in any case, dominated by a cartel of foreign producing nations. Furthermore, it is readily seen that the three mergers make little change in the industry's competitive structure.

Anticipating that the Federal Trade Commission (FTC) would put only modest prenuptial conditions on these corporate marriages, critics fell back on a new line of argument in the hope of attracting enough congressional attention to get them annulled. They rushed to the media with new ideas that admittedly sound good but, although long on sound, are unfortunately short on substance.

The New Ideas

Probably the most popular new idea is that acquisitions drain funds away from new investment. Or to put it another way, purchasing existing assets is economically inferior to creating new ones. The notion is, I suppose, that if someone chooses to buy an existing asset instead of a new one, fewer new ones will be produced, and hence new investment in the economy will be reduced.

This reasoning is wrong. Perhaps the best way to understand why is to consider the largest investment that families typically make—their own homes.

A family always has a choice of whether to buy an existing home or have a new one built. If it chooses an existing home, it is contributing just as much to the total demand for housing in the country as if it built a new one. If the demand for housing exceeds the number of homes that already exist, no amount of sales and resales of that existing stock will satisfy the demand. At some point someone, either a new buyer or the recent seller of an existing home, will choose to have a new home built. This will happen because the continual bidding up of the prices of existing homes will make building a new home more attractive. Thus, the choice of one particular buyer between new and used does not affect the number of new homes built.

It is also obvious from this housing market metaphor that borrowing money from the bank to finance the purchase of an existing home does not deplete the fund of money available to build new homes or to invest in the economy generally. Typically, the seller of the existing home will use the proceeds of the sale to buy another existing home or to build a new one. If he builds a new one, the original bank loan winds up financing a new home. If he buys an existing home, the seller of that home winds up with the money from the bank loan. I think it is easy to see that if there are not enough homes to satisfy the demand, all of the additional bank loans actually wind up financing newly built homes. Again, the deci-

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sion by a family to build a new home or buy an existing one has no real effect on the capital available for other investments in the economy, just as it has no effect on the number of homes built.

The metaphor also explains why it would be a terrible idea to restrict the purchase or sale of existing assets. Suppose a law is passed that makes it difficult to purchase or sell an existing house, the motive being to encourage the building of new homes. The benefits of owning a home depend on the value of living in it each year and the expected amount it can be sold for in the future. Clearly, whether you built your house or bought it used, if its resale is restricted in the future, its value as an investment will be less and therefore the attractiveness of investing in houses, used or new, will be diminished. The price of existing houses will immediately drop to reflect their lower future worth. And fewer, not more, houses will be built.

Furthermore, if families are restricted in buying and selling homes, they will not end up in the houses they prefer to live in. Older families will be stuck in homes that have become too large for their needs; younger families will have difficulty moving up to these same larger homes.

The lessons for the oil industry merger issue are clear.

- The decision of any one company to buy existing oil assets instead of investing in new ones does not affect the amount of new investment.
- Bank loans made to finance oil acquisitions do not disappear from the economy. Rather, the funds received by the sellers are available for new investment in the oil industry or any other industry; and the amounts to be invested in oil exploration, for example, depend only on the price of oil (which is set outside the United States) and the exploration prospects available in the United States.
- Restrictions on mergers or acquisitions in the oil industry would *reduce* the amount invested in the oil industry, that is, in crude and natural gas production, refining, marketing, and so on.
- Restrictions on mergers or acquisitions would also mean that industry assets would not wind up in the hands of the managements that could make the best use of them.

The latest new idea is that the taxpayer is somehow uniquely subsidizing acquisitions and creating an incentive for companies to merge, because the interest on the loans used to finance acquisitions is a deductible expense. Actually, whatever the purpose of a loan, all interest paid is a tax deductible expense to corporations or individuals, just as it is taxable income to the lender. If a corporation borrows money to buy back its own shares, thereby changing nothing but its capital structure, the interest is tax deductible. That one corporation is capable of borrowing large sums to buy another reflects the fact that it has accumulated unused borrowing capacity up to that point. Since the interest it pays is deductible no matter how it uses this borrowing power, there is no bias or incentive in favor of acquisitions.

The Case for Mergers

Mergers can offer significant benefits to the economy by making possible a number of efficiencies. Sometimes there are scale economies, so that the increase in firm size itself lowers the cost of production. Other economies can take place through what might be called the marriage of complementary factors (for example, a firm with strong new products merges with a firm strong in marketing), or through the rationalization of production facilities (for example, two vertically integrated firms in the same business find that shutting down the weakest units in the chain in each firm enables the merged firm to operate only the most efficient units), or through opportunities for technology transfer between firms. Mergers also offer an opportunity to replace weak managers with a team that will employ the firm's assets more efficiently. Some of these goals can of course be achieved by transactions other than mergers—technology sales between firms, for example—but such transfers may involve prohibitively high transaction costs.

Sometimes it takes only the threat of a merger to achieve some of its benefits. In an environment where takeovers are easy and legal, for example, weak managements have an incentive to reform themselves to avoid being ousted in the event of merger or acquisition.

There is evidence that Socal's acquisition of Gulf Oil has the potential for significant efficiencies. Based on estimates from the *Value Line Investment Survey*, Gulf earned only an 8.2 percent return on its assets in 1983, compared with 10.5 percent for the integrated petroleum industry as a whole and 11.2 percent for Standard Oil of California. This suggests that there is room for improvement in the utilization of Gulf's assets.

The true effects of a merger are often best revealed by the reaction of competitors. If the oil industry were heavily concentrated and if the recent mergers really augmented monopoly power, the merger announcements would have been greeted with concealed applause from other firms in the industry. The reason is that, in exercising their monopoly power, the merged firms would cut their production in order to achieve higher prices. The other firms would benefit from such a development, because they would be able to sell more than they do now at even higher prices.

Judging from press reports, these other firms—which are in an excellent position to make a judgment—do not expect that that will happen. Indeed, some of them actually appear to be trying to fight the mergers on Capitol Hill. The spearhead of the antimerger movement in Congress is an oil-state senator with close ties to many oil companies. This implies that the merged firms are thought to be potentially more serious competitors than they were before, presumably because they will be more efficient. (I dismiss the idea that small oil companies fear that the larger oil companies will engage in predatory tactics. Claims of this sort have been made for so long with so little supporting evidence in the face of so much contradictory evidence that they no longer deserve attention.)

Moreover, the evidence on concentration shows that the potential for monopoly power is very low. For example, based on 1982 data on U.S. crude oil reserves, the Socal-Gulf and Texaco-Getty mergers would increase concentration from just 29.8 percent to 30.0 percent at the four-firm level and from just 44.5 percent to 49.3 percent at the eight-firm level. And for natural gas reserves, these mergers would raise the four-firm concentration ratio from 23.4 percent to 24.3 percent and the eight-firm ratio from 35.7 percent to 37.5 percent. In both cases, these are very small changes to numbers that are already small. (In some parts of the country, the mergers might have resulted in more significant concentration in refining and marketing assets. But the merging companies have agreed to dispose of assets that raise concentration issues with the FTC.)

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The legislative proposal for halting the recent oil company mergers might have been more appropriately labeled The Big Oil Management Protection Act of 1984, for the principal economic effect of banning these mergers would be to keep existing assets from going to new, presumptively stronger, hands. No one would seriously propose legislation whose announced purpose was to protect managers of large companies from their stockholders. Yet, as a practical matter, there is often no other way to displace the management of a large widely held company than through merger or acquisition. And so another important source of merger opposition from within the petroleum industry derives precisely from some management's fear of being thrown out. The fear is well founded, but it is not one that should evoke sympathy from consumers or investors. Their interest, like the interest of the public at large, is in having business enterprises run efficiently. ■