DRIVING FURTHER DEALS

GUEST OPINION

By Jennifer Kreischer

> "Expect U.S. power and gas deals to become more complex..."

This nation saw a full flowering of large deal activity last year. Consolidation of the U.S. utilities sector continued during 2005, with the volume and value of deals setting new highs, according to Power Deals, PricewaterhouseCoopers' annual survey of power generation and transmission mergers and acquisitions.

During 2005, U.S. companies participated in 80 deals raising $62.6 billion, compared with 70 deals with proceeds of $56.4 billion the year before. However, when the impact of mega-deals — those greater than $5 billion are excluded — average deal size fell from $304 million to $256 million, as the number of deals raising $100 million or more dropped from 49 to 46.

With all of 2005's top-10 deals raising more than $1 billion, compared with seven out of 10 in 2004, four of the world's 10 largest utility deals last year involved U.S. companies, the same number as in 2004. A majority of last year's deals were done from a position of strength. The back–to-basics strategy followed by most utilities in recent years produced strong balance sheets, good credit ratings and predictable cash flows, leaving companies in a healthy position to pursue deals. With organic growth at about 2 percent, and Wall Street expecting 5 to 6 percent, strong companies are hitting the acquisition trail hard, having realized most of their organic growth potential.

U.S. deal activity reflected several global trends including the emergence of "super regional" companies, as more companies made domestic, rather than cross-border acquisitions. Only one of the top-10 deals involving U.S. companies was cross-border in 2005, compared with four in 2004.

The United States remains ripe for consolidation as the 10 largest power companies control 33 percent of the market, compared with about 80 percent in the United Kingdom. As companies seek vertical and horizontal integration, expect more deals like Duke Energy's $14.3 billion purchase of Cinergy. That deal expands Duke's territory from North Carolina to Ohio, Indiana and Kentucky.

FPL Group's $11.2 billion acquisition of Constellation Energy illustrates another type of consolidation — one that reduces dependence on gas, given its volatile price. The deal gives FPL a mix of oil, gas, coal and nuclear power stations as well as a highly respected trading organization.

Financial buyers continued their heavy involvement in the North American power and gas sector last year, with infrastructure funds emerging as a new market force. In the world's fourth-largest cross-border electric deal of 2005, Shell and Bechtel sold InterGen and 10 of its power plants for $1.8 billion to a consortium consisting of AIG Highstar Capital II, a U.S. private equity fund, and the Ontario Teachers' Pension Plan. Infrastructure arms of the two Australian investment banks — Macquarie and Babcock & Brown — also acquired U.S. targets last year.

Other major financial buyer deals were Berkshire Hathaway's purchase of PacifiCorp's regulated assets from Scottish Power and the much talked-about sale of Texas Genco to NRG Energy, a merchant generator. Four private equity firms — The Blackstone Group, Hellman & Friedman, Kohlberg Kravis Roberts & Co. and Texas Pacific Group — made a quick and spectacular return on their 2004 investment of about $900 million, netting $4 billion in cash and $1.8 billion in stock after debt from the sale to NRG.

Despite last year's repeal of the Public Utility Holding Company Act, regulatory developments remain the wild card in U.S. markets as state regulators have stepped up their involvement in transactions. As rate freezes expire, the main issue facing state commissioners — many of whom are fairly new — is how to handle requests for rate increases without hitting customers with too much sticker shock. Cash infusions by private equity firms and hedge funds could help, but commissioners are wary of many financial investors' short investment timelines. Pension and infrastructure funds, with their longer horizons, are viewed more favorably in many cases.

Expect U.S. power and gas deals to become more complex as the power supply chain expands and new types of investors enter the market. In this environment, companies must pay close attention to deal analysis, financial reporting, valuation and forecasting.

Jennifer Kreischer is a partner in PricewaterhouseCoopers' transaction services power and utilities group.

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