NEW DIRECTION IN M&A

By Ken Silverstein   Illustration by Clay Sisk

Utilities are perking up. After suffering from a serious case of the drabs, companies have been following orders and focusing on core abilities and customer service. Now that the economy is getting ever brighter and the demand for power is rising, utilities of all sizes may seek to gain mass in an effort to stay viable.


SISK

> **THE SHEER MAGNITUDE OF THE PROPOSED MERGERS WILL HAVE TO CAUSE THE REGULATORS PAUSE.**

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NATIONAL GRID UPGRADE

National Grid intends to invest $1.2 billion in improving its New York electric grid to better meet state reliability standards.

New York regulators are imposing $8.8 million in fines on National Grid for having too many lengthy outages, reported the *Buffalo News*. The company plans to replace 600 miles of lines this year.

Any financially solid company with a pot of cash has its eyes open. Mergers are back in the news because companies with high fixed costs can improve earnings through sharing and reducing variable costs across their combined operations. The secret, though, is to make buys that are reasonably priced with complementary businesses. Companies are pressured once again to increase earnings. The rationale behind getting bigger and increasing cost savings are compelling for many executives. In fact, some companies divested of generation are picking up these facilities as a way to protect their customers from market volatility. In essence, by owning and managing their own assets, they can make better predictions as to how fuel costs will affect them.

"These mergers will happen," says Jim Dillavou, partner with Deloitte & Touche in Dallas. "While there will be some opposition, these will settle out by companies being able to sell the benefits of the merger. To the extent there are cost savings, there will be some pressure to share those savings with the ratepayers."

Will it be the land of the giants? Exelon is buying Public Service Enterprise Group while Duke Energy and Cinergy are merging. Meanwhile, Niagara Mohawk is picking up Keystone and Constellation Energy is uniting with FPL Group. And Warren Buffet's Berkshire Hathaway is buying PacifiCorp. Analysts say the mid caps — the smaller regional utilities — will be forced to partner with others their own size in contiguous regions to avoid getting eaten up by the behemoths.

But has the industry learned from razzle-dazzle days of the last decade? The lessons were so blistering that they surely know to do their homework as well as to ensure that any deals are properly integrated, experts say. Many utilities paid a huge premium to acquire other companies. The synergies that were expected, however, didn't materialize while productivity levels stagnated.

SHEER MAGNITUDE

High stock values helped ignite merger fever in the previous decade. That permitted companies to exchange common stock — or inexpensive capital — for ownership stakes. But the more common arguments in recent years have been the perceived need to span geographies and win new customers. With that approach, companies could increase revenues without adding significantly to their expenses. Meanwhile, the scale that companies would achieve would give them greater leverage in the market.

The results are noticeable. According to PricewaterhouseCoopers, the total deal value in 2005 was $196 billion. That's up from $123 billion the year before. North America accounted for about $60 billion of that with a handful of deals exceeding $10 billion. The consulting firm says that the trend towards the "super regional" utility will continue. Why? Organic growth in most territories is around 2 percent earnings per share. But through regional consolidation, it could be 5 percent.

If the Exelon-PSEG deal goes through, it would create the nation's largest power generation company, with $79 billion in assets, serving 9 million customers in Illinois, Pennsylvania and New Jersey. The acquisition by Exelon would be worth $12 billion in stock. The main contention that regulators are hearing is that the proposition would harm consumers by allowing the utilities to aggregate market power with their 52,000 megawatts of generation.

"The sheer magnitude of the proposed mergers will have to cause the regulators pause," says Mark Rossi, an executive with Fairfax, Va.-based Gestalt. "Exelon, for example, has promised to divest some generation assets. In the absence of that, its market power would be huge. Now that federal law removes some barriers, utilities will have more options. But it won't be any easier. They still have to deal with state regulatory proceedings. They still have to show some value to investors."

Executives of both Exelon and PSEG said that consumers and shareholders alike would benefit. They estimate that at least $500 million in cost savings would take place within two years, which would occur in part by eliminating 1,400 jobs out of 28,500.

In the past, mergers were poorly executed. The result, says the consulting firm KPMG that studied 700 mergers that took place between 1996 and 1998, is 83 percent of them failed to unlock value one year after the transaction, and 30 percent actually destroyed value.

Those results could improve. According to the Conference Board, smart companies have learned lessons. Before a merger, utilities must have detailed plans ready well in advance and the resources to assure good execution, it says. After the transaction, they must maintain personnel and the skill-sets that satisfy those customers wanting continuity.

"Before, utilities just followed the Enron ball," adds Dillavou with Deloitte. "They got caught in the hype. Today, there is a much clearer focus. They are trying to provide stable earnings and focus on cost and cost savings. They realize there is financial strength from owning and building assets."

Indeed, one of the strongest lessons is that the ability to manage risks requires a diversified portfolio. However, the acquisition of assets may lead to market power. Take Exelon, which had gobbled up Pennsylvania-based PECO in the 1990s. Part of that entity had to divest generation assets.

MARKET POWER

Consumer organizations say the concentration of generating assets and marketing power within a regional wholesale electricity market will lead to higher prices for consumers. And, the acquisition of PSEG by an out-of-state holding company will severely limit the ability of New Jersey regulators to protect consumers, some say.

Ratepayers will bear the costs associated with the proposed buy-out, says New Jersey Citizen Action. According to PSEG's most recent annual report, PSEG and Exelon expect to incur $70 million in transaction fees and another $700 million in integration costs over four years. The expected benefits will go unrealized because of this high cost, it says.

"Exelon's buy-out bid offers no evidence that this merger is in the public's interest," says Ev Liebman, program director for Citizen Action. "Synergies for CEOs do not translate into positive benefits for the millions of ratepayers who could end up footing the bill."

There's less concern about market dominance occurring in the Northeast and Midwest, where there are vibrant wholesale markets and more worries in places like Florida, which are isolated.

"The bigger they are, the more political power those companies will have," says Sean Boland, partner with Howrey law firm in Washington, D.C. "They will hold tremendous sway over regulators; however, we won't have a huge antitrust problem. What if at the end of the day, we end up a few utilities? That's not the end of the world."

The market will likely work its will, producing more and more mergers that will create corporations with the potential to get even bigger.

If abuses or problems arise, there will be a clamor for change and new regulations. Furthermore, regulators will have the difficult job of promoting competition among a shrinking number of players.

FOREIGNERS COME CALLING

National Grid's KeySpan Deal

By Richard Korman

WITH THE ANNOUNCEMENT that National Grid, the U.K.-based electricity and gas utility, plans to buyout KeySpan Corp., the Long Island-based gas and electricity utility, you may be tempted to believe that more cross-Atlantic energy company unions could be in the works. After all, deregulation, mergers and acquisitions are unfolding on both sides of the ocean. Well, think again.

The $7.3-billion KeySpan buyout is motivated more by individual corporate goals and the drive for bigger size – and should not be taken as a harbinger of more to come.

"KeySpan was a bit of an exception," says Michael Heim, a gas utilities analyst and vice president of broker A.G. Edwards. This is because non-U.S. investors are likely to show an interest in larger electric utilities, not smaller-size gas utilities. "'No one plans to come over from Europe and buy a $100 million market cap gas distributor," says Heim.

Another reason is that investments in U.S. utilities haven't always proven to be no-brainers. In March, Glasgow-based ScottishPower received regulators blessing to sell Portland, Ore.-based PacifiCorp to MidAmerican Energy Holdings Co., Des Moines, for $5.1 billion in cash.

ScottishPower had bought PacificCorp in 1999. The investment has proven to be a liability to ScottishPower's leaders, who reportedly learned that PacifiCorp needed billions in capital expenditures.

Finally, utilities need to know their regulators well, and that means regional focus. "A core competence of utilities is their regulatory relations," says Tom Champion, director of energy policy for Medley Global Advisors, New York City-based policy advisors. "What does a buyer from another country know about Maryland or Oregon regulations?"

A local utility owned by overseas investors doesn't spark the same kind of concern as U.S. ports being managed by a company whose parent is based in Dubai. But regulators are likely to examine more closely non-U.S. control of a U.S. utility.

National Grid USA has substantial gas and electricity distribution businesses in New York and New England and operates 9,000 miles of electrical transmission lines in those areas. Relations between National Grid and New York state regulators have been good, says Champion.

The deal doubles the size of National Grid's business in the United States and creates the third largest energy delivery company in the nation, noted National Grid's CEO Michael E. Jesanis.

KeySpan CEO Robert Catell said KeySpan had for a long time sought a deal that would allow it to become part of a larger company. However, repeal last year of the Public Utility Holding Company Act sped the process.

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