The Evolution of the Energy Business

From the Dull, Stagnant, Over-Regulated, Pseudo-governmental to One That Is Market-Oriented, Fully-Commoditized, Partially Regulated, Imperfectly Competitive and Technologically Driven

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FIRST POINT: BASIC PREMISE

There is no such thing as an electric, gas, central station, distributed generation, transmission, regulated or unregulated market, independent of other markets. Nor is there a safe, must-run or oligopolistic market. Customers want reliable, low-cost energy to perform tasks, or they want someone to figure out how to eliminate or more efficiently perform those tasks. Every sector of the business competes with other sectors. Information in the form of prices impels market players to take action to achieve their goals in the optimal manner. Technology will enable them to do so. *In short, everything is up for grabs and nothing is safe.*

SECOND POINT: DIRECTION

Demand for the basic energy product will grow slowly. This is an industry that requires a heavy fixed asset investment, whose supply was formerly—but is no longer—controlled by regulators. The basic product looks like a commodity, subject over time to cycles caused by injection of new supply into the market, or by slow withdrawal of supply caused

by gradual closedown of old facilities. To the extent that cost of new production or transportation declines as the result of the introduction of new technology, firms can and will enter the market despite an apparent glut of existing capacity. *In short, you can't make it on the commodity.*

THIRD POINT: HISTORY REPEATS

We can look at the history of industries into which competition was introduced. First stage, before deregulation: steady, high level of profitability, not a big gap between best and worst firms. Second stage, deregulation: earnings plummet, take on a jagged pattern, and the previous bottom of the heap companies stay at the bottom, except farther down in the pack than before. Third stage, after the fall: market leaders bring profitability to reasonable levels, the rest of the pack continues to do poorly, and earnings are not as steady as before. As part of the process, prices fall, firms cut costs dramatically, and the industry consolidates. In short, unless a utility is really good, the customer picks up the benefits and the first rate companies pick up the pieces.

FOURTH POINT: INFORMATION COUNTS MORE THAN PRODUCT

A utility must know, better than its competitors, what customers will want: where, when, what and how much. If it does, it gains an advantage over competitors. It has to understand the delivery system, and how it can use it to advantage. Thanks to rigid transition programs, the knuckleheaded regulatory regime that has helped fossilize the transmission network over the past decade, lack of proper electronics at the consumer level, and the manner in which power plants have been sold, market players with superior information have perhaps four or five years, at most, to exploit that information and natural gas companies cannot easily push distributed resources as a new line of business.

But, once the consumer gains real time information and acts on that information, and once a combination of looser regulation and new technology enables transmission operators to enlarge their system, then electric generators and marketers have to worry that both competitors and consumers will react to prices, and drive down profits. *In short, if a utility*

really does know more, and enters markets on that basis, it must make sure that it does not pay a price for entry that it cannot amortize within a few years.

FIFTH POINT: CASH TO THROW AROUND

Electric utilities did what natural gas pipelines, telephone companies airlines, truckers and railroads never had the skill or chutzpah to pull off. They managed to recover the supposedly stranded costs endangered by deregulation up front, or they managed to sell off those endangered assets at phenomenal prices, so that many utilities ended up doing better from the deregulatory process than if they had remained regulated monopolies. In order to maintain stock prices above the value of the cash, though, in this instant-gratification market, the utilities have to invest those funds rapidly. *In short, a utility needs to work fast, in competition with other utilities that have the same problem, in order to maintain value, but a misstep could easily destroy value.*

SIXTH POINT: EVERYONE IS DOING THE SAME THING

Or so it seems. Utilities can't achieve above average growth in a slow-growing market by doing the same thing as everyone else, especially if they overpaid for the assets that they are using. In a business with heavy fixed cost, any over-capacity over time leads to cutthroat competition. That could even happen in telecommunications, where every newly announced system can carry the entire traffic of the Internet, it seems. Do the arithmetic. All 100 companies cannot increase market share from 1% to 2%. In short, if a utility plans to do the same thing as everyone else, it had better do it better than anyone else.

SEVENTH POINT: TECHNOLOGY WILL NOT STAND STILL

Every investment requires assumptions (or predictions) of technological change. Reading through Wall Street utility reports, or company annual reports, or FERC's Order 2000, and adding into that brew the decline of industry R&D, one would have to conclude that energy technology has been frozen in place for the convenience of investors and incumbents. Or that the introduction of new technology will come at a

snail's pace, to coincide with the amortization of existing investment.

Maybe. But remember that new entrants could use new technology against incumbents. As examples, distributed generation that cuts the profits of existing generators, and Internet customer interfaces that cut out middlemen and demolish the utility's customer contact. Remember, too, that buyers and builders of power plants, I hope, are doing more than looking at forward price curves for the coming year. They, too, have to make assumptions about whether regulation will provide incentives to decongest transmission, whether new technologies will allow transmission providers to do so economically, and what impact an opening of transmission will make on the value of their power plants. In short, does technology create risk for incumbents, and is that risk factored into the returns that they seek?

EIGHTH POINT: GET THE RIGHT FINANCIAL POLICIES

Over time utilities evolved a financial policy and shareholder base premised on low risk, capital-intensity, domestic assets with long lives and low pace of obsolescence, captive customers and a regulatory safety net, and elderly, low risk shareholders seeking a combination of safety, current income and moderate growth. Meaning, 30-40 year depreciation schedules, over 50% debt, interest coverages in the 2-3x range, 75% payout of earnings as dividends, deferral of expenses and capitalization of costs.

As the industry and its affiliates move into a more competitive and international markets, they retain most of the same policies, and a lot of the same shareholders. Competitive companies seeking growth cannot maintain those policies. The electric industry, despite sale of assets and many dividend reductions, still maintains the old financial policies, and possibly, might now have more financial leverage, but is not showing it because it has learned the virtues of off-balance sheet financing. *In short, the business may become riskier, but the financial policies currently in vogue don't seem to take that possibility into account.*

NINTH POINT: DON'T JUST MERGE

Everyone tells utilities about the value of scale, of synergies (a word that should be banned), of the need for more customers and for lower

costs, and how a merger can transform a company. No argument on any of those points. The problem is that the acquiring company can pay a price that more than compensates the seller for all of those benefits, in which case, the buyer brings no benefits to its shareholders. Remember, too, that in this regulated industry, mergers take years (which is forever in any competitive business), the regulatory approval process might prevent either company from making strategic moves during the process, state regulators want to extract blood from the turnip whenever possible, and big shareholders sell the stock because they view merging companies as dead money for the entire waiting period.

So merger can turn into a painful process. Shareholders want to get something out of it, and I am afraid that the usual answer, "accretive to earnings per share" will no longer suffice, especially if the accretion came about from financial engineering alone. In short, utilities should merge to do something worthwhile, or they need not bother.

TENTH POINT: THE MARKET IS NOT HAPPY

Electric utilities sold off power stations at big profits, they accomplished astonishing feats of regulatory acrobatics when they won those stranded cost settlements, and now they have the freedom to play, big time, in the unregulated and the growing international arenas. Yet, electric utility stocks have not only done terribly on a relative basis (which one would expect in a roaring bull market), but many have done terribly on an absolute basis, which shows that a rising tide does not lift all ships.

Something is wrong. Maybe investors do not believe that the average electric utility has the necessary combination of management and financial strength to prosper in the new world. Maybe they do not see where the growth will come from. Maybe they see more risk than do the managers. Maybe they don't like the new investments they have seen to date.

I do not know, but that lack of market enthusiasm, translated into low share prices, deprives the electric companies of the currency that they need to grow through acquisition, and it could make them targets for outsiders who see them as a cheap means of entry into a large market. *In short, the market is telling utilities something, and maybe they should try to decipher the message before moving ahead.*

What's the message, *in toto*? New risks require new strategies, and right now utilities have more new risks than new strategies.

ABOUT THE AUTHOR

Leonard S. Hyman, CFA, is a senior industry advisor to Salomon Smith Barney. Previously he was managing director of Fulcrum International Ltd., as well as an independent consultant specializing in the economics and finances of energy and telecommunications utilities.

From 1978 to 1994, as head of the Utility Research Group and first vice president at Merrill Lynch, he supervised and maintained equity research on foreign and domestic energy and telecommunication utilities. He was a member of privatization teams for offerings of British, Spanish, Mexican, Argentine and Brazilian utilities and consultant for other restructuring studies. Prior to joining Merrill Lynch, he was a partner at a New York Stock Exchange member firm and an officer at Chase Manhattan Bank.

Author of *America's Electric Utilities: Past, Present and Future*, author of *The New Telecommunications Industry: Evolution and Organization* and editor of *The Privatization of Public Utilities*, he has contributed to other books and to professional journals.

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