

BUYING TIME:

The New Merchant Power Dialectic

*Roger D. Feldman, Principal
Bingham Consulting Group LLP*

Power business strategists have all long since come to the conclusion that the unique monopoly service of generation provision has become a commodity business, in which skill at cost control, operating efficiency and price speculation through trading are the drivers of success. On a parallel track, regulators increasingly derive self satisfaction from the increasing conformity of their domains to true marginal cost competition. For all these players, the power business finally seems to be fitting into that Economics/Finance 101 box we know so well: valuation of alternative strategies discounted cash flow streams.

This almost Newtonian certainty of how the world works also is to be found in analysis of the current acquisition boom triggered by deregulation, i.e. it is all interpreted as bidder match-ups of present value cash stream analysis to corporate strategy. Sales of assets are driven by regulatory compliance or core business focus. Purchasers are drawn of assets by one of three basic approaches: economics of scale, initially through the fuel supply chain; asset backed trading of retail and wholesale energy services; and operational efficiencies based on improved management of specific sites. Power strategies are thus characterized as all about alternative appraisals of cash flow potential; different cost of capital hurdle rates and different forward price curves for the regional markets into which the particular auction is being carved.

Arguments about regulatory public policy in this Newtonian DCF would therefore proceed from the question: are proposed contractual or institutional relationships likely to promote the continued creative clash of competing strategies? The ultimate criterion for blindfolded public

policy becomes: is the playing field really flattened? If it is, the presumption is that the economic results of the marketplace will serve the public interest best—in terms of service and price.

It turns out, however, that “rational” businessmen participating in power auctions and greenfields investment decisions increasingly may be thinking about their investments, in a different dimension than the regulators assume. The challenging inference of this conclusion is that policy makers need to re-examine, whether the policies they establish really will elicit from competitors the response from them best for the public. Space constraints permit only the outlining of the new valuation private-public point-counterpoint in this article. It may, in fact, result in a new regulatory policy dialectic.

Private Point: Strategy is viewed increasingly not as a static event, validated by checking the DCF numbers. Each decision is viewed in terms of the options *over time* it creates; and the quantitative valuation of a series of such options. Strategy is not static; it involves the contemplation of the creation of a series of such options. Two complementary articles in the *Harvard Business Review* explain this lucidly—“Investment Opportunities—Real Options; Getting Started in the Numbers,” (July-August 1995) and “Strategy as a Portfolio of Real Options” (July-August 1998).

In the latter, the author, Timothy Luehrman, introduces the notion of a very special garden plot called “option space” defined by two metrics associated with the value of the option of being able to defer an investment: The first is an old friend Net Present Value (NPV) enhanced by the value of the ability to defer an investment, i.e. NPVq. (in effect, a value to cost metric). The latter is a volatility metric, i.e. how much things can change before an investment *must* finally be made (in effect, the impact of deferral on what NPV may be realized).

Of this garden plot, Luehrman says: “Option space can help address the issues an active gardener will care about: whether to invest or not (that is whether to pick or not to pick), when to invest, and what to do in the meantime.” (It certainly appears that our beloved power market is really just one subset of this “garden plot.”) For us as businessmen, while the further reasoning is complex and dense, the goal is clear: to maximize profit.

Public Counterpoint: For policy makers, this thinking on the part of private investors logically should be related to the deregulation policies they should follow. Should regulators think in terms of maximization

for the private sector of option space? Or, should they fear that the pursuit of option space may be contrary to reliable supply or equitable prices? Is it desirable for too few parties to hold too much option space? Should regulatory focus be on market volatility reduction and/or expedition of private decision-making even at the price of option space reduction? Should it be on preventing the gaming of option space (as, for example, in the transmission field)?

Merchant power planners buy time, and bet on time. Policy makers historically have sought public satisfaction at virtually every instant as time passes; now the current vogue is to seek "ultimate" satisfaction through free market stabilization. Neither analytic approach seems wholly appropriate. As option space economics succeeds NPV as the actual basis for private decision-making, it behooves public policy makers to factor this fact into their decision making also.

The new energy policy dialectic is just like the old song: "Sitting at the auction policy dock, buying time."

ABOUT THE AUTHOR

Roger D. Feldman is co-chair of the Project Finance Group of the century-old, 325-attorney law firm of Bingham Dana LLP, which has closed several merchant plant transactions, and currently is in the process of advising several others. He is also a principal in the Bingham Consulting Group, LLC, a wholly owned strategic and public affairs planning affiliate of the firm and has participated in groundbreaking project finance and securitization projects for the US Department of Energy in that context.

With over 30 years of practical legal experience, public service as deputy administrator of the Federal Energy Administration and on the Environmental Protection Agency's Financial Advisory Board, and Washington editorship of the *Merchant Power Monthly* (previously *Cogeneration Monthly*) and *The Construction Business Review*, Mr. Feldman brings significant capabilities to energy project transactions of all types. He is a graduate of Brown University, Yale Law School and Harvard Business School.

Bingham Dana LLP, Suite 400, 1200 19th St. NW, Washington, DC 20036-2400; (202) 778-6150, fax 6155.