

Electric Utilities In 2007

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A century ago—in the year J.J. Thomson discovered the electron—electricity, gas and traction companies battled for markets, and corrupt city councils demanded their fair share of the take. One tycoon became so disgusted with the confusion and dishonesty that he decided to bribe the legislature to set up an honest, state-run regulatory agency that would bring order to chaos.

But he was found out. The scandal set back the cause of regulation until 1907, the year in which the electric washing machine and the vacuum cleaner were invented. By then, electricity sales had septupled from 1897 levels, and three states had established utility regulation.

In the coming decade, 1997 to 2007, the utility business could undergo similar dramatic change, but it will move toward less regulation and more competition during a period of slow growth. Management will have to work harder to achieve success, however, because much of the profits will have to come not from a growing market but from the pockets of competitors.

PRESENT FIRST

Today, most electric utilities generate electricity, transport it to population centers over high-voltage transmission lines, deliver it to the customer over low-voltage distribution lines, and then send the customer a bill that covers the cost of the energy, plus all the other services rendered, including the costs of such hidden services as keeping spare capacity on the ready in order to assure reliability.

That structure—the vertically integrated utility, bundling all its services for one price—will change. The generators (utility and nonutility) will compete on a price basis to sell output on the local electricity equivalent of a stock exchange. The buyers will include electric companies seeking supplies to sell to their customers—large consumers of electricity buying for their own accounts, and marketers that will resell the power to their own customers. An independently managed transmission system will, for a fee, transport the electricity and arrange for the special services required to keep the electric network running (Figure 1). Local distribution companies will build and maintain the

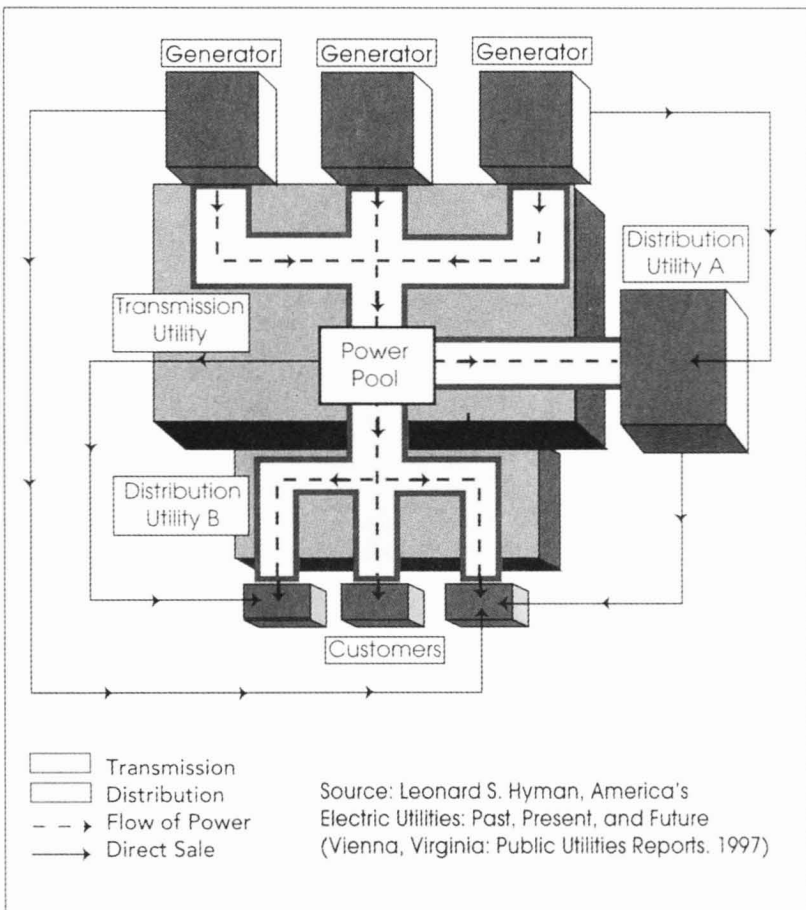


Figure 1.

delivery infrastructure, carrying electricity supplied by others for a transportation fee, and also furnish electricity to those consumers who choose not to deal with other suppliers. Most observers expect the generating market to operate without regulation, but believe regulators will continue to set prices for the transmission and distribution sectors.

The business, though, will have new players—not just the power marketers of today, but virtual utilities. Those organizations will supply a range of energy services, but not necessarily own the assets needed to supply these services. “Packager” might convey the idea better. The virtual utility will attempt to provide a competitive energy service in the most efficient manner possible, assembling its offerings from a variety of sources and managing customer usage to optimize the expenditure on energy. The virtual utility will buy components of the package from different suppliers, primarily existing utilities, to select each component’s most competitive offering. Utilities will have to unbundle the services and price each part of the bundle competitively in order to sell the service.

YOU CAN GET THERE FROM HERE

Utilities, in order to position themselves for the new world, must answer the following questions:

- Should we merge or partner with other utilities to achieve critical mass in operations and markets?
- Should we merge or partner with a gas company to create a full-service energy firm?
- Can we recover costs incurred during the regulatory era when attempting to do so through maintaining high prices might result in a loss of customers?
- Should we continue to build regulated power plants?
- Should we maintain an integrated utility or divest those operations in which we have no competitive advantage?

- Should we encourage or discourage the rapid development of a competitive market?
- What is the correct financial policy for a competitive utility?
- How should we invest excess cash flow?
- In light of slower growth in the United States, should we develop international operations?
- Do we have the right set of talents to succeed in a competitive world?

SURVEY SAYS!

No industry consensus exists for any of those questions, which is not surprising, considering the diversity of cost structures and managerial goals within the industry. What is more surprising is the lack of attention to the following three fundamental issues.

Financial policies. Utilities have made hay with heavy use of debt, slow plant depreciation, deferred expenses, little working capital and a high portion of earnings paid as dividends. Companies in competitive industries that want to survive from cycle to cycle avoid such policies. Some utilities have begun to readjust their policies, gradually, but many more appear to be putting off action in the hope that competition comes later rather than sooner.

System operations. The electricity supply industry operates as a network system. To run efficiently and reliably, the network requires rules of the road, incentives for those who provide the services to do the best possible job, and penalties with teeth for those who do not meet their obligations. So far, neither regulators nor utility managers seem to regard the system's transmission and network operations as real businesses that could function well in a market. The result of this attitude might be a less reliable system because it lacks the means to pay market prices needed to encourage firms to make investments in the system.

Better regulation. Regulation might diminish over time, but it will not go away. Existing rate-of-return regulation in the United States provides little incentive for more efficient operation. Price-cap regulation incites management to cut costs, but possibly corners as well. The system does not provide price signals to consumers in a way that encourages societal efficiency other than by accident. The mixed system of competitive and regulated markets, as contemplated, may send incorrect signals to industry participants as well.

FEARLESS FORECASTS

A decade from now, consumers will continue to buy electricity and natural gas, but the sellers will look as different from today's utilities as the mall does from the general store.

Energy suppliers—not gas or electric utilities—will sell energy and related services, aided by sophisticated communications and control systems. Energy firms will have separated regulated from unregulated operations, spinning off or selling unwanted assets.

The ownership of energy suppliers will shift as federal laws that limit ownership are repealed. Control groups will take over and refocus the utilities. Individual investors will concentrate on ownership of the distribution and transmission entities, which retain the safety characteristics of the old utilities.

The distinction between utility and nonutility generation will end. Generators of all kinds will require deep pockets, sophisticated knowledge of markets and a willingness to take risks.

Each of the component parts of the industry will put into place appropriate—and different—financial policies and risk-management procedures appropriate to their circumstances.

Utilities that have built up operations all over the world will rationalize those holdings, create coherent regional organizations, and unload the failed investments made at a time when going international was the rage.

WHO WINS?

By 2007, electricity will constitute a component of a larger energy and utility services industry that sells electricity, natural gas and possibly water, propane and telecommunications. Customized service will meet the needs of consumers of all sizes. The dominant firm in the industry, the virtual utility, may look more like a financial organization or a mass marketer than the traditional converter of raw material to energy. Emphasis on market-based pricing should lead to more efficient use of resources.

If the process works right, the consumer wins.

ABOUT THE AUTHOR

Leonard S. Hyman, CFA, is a senior industry advisor to 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.

For more than a decade, Mr. Hyman was cited by *Institutional Investor* as one of the leading research analysts in his field. He is a Chartered Financial Analyst (CFA). He holds a BA from New York University, where he was elected to Phi Beta Kappa, and an MA in economics from Cornell University, where he majored in industrial organization and minored in Latin American studies.

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