

Top 10 Winners in the Electric vs. Gas Sweepstakes

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Editor's Note. Mr. Rudden's article does not identify "either/or" winners—gas versus electricity—but rather predicts what will evolve as the conventional wisdoms and mind sets of management are overturned. What will distinguish winners from losers is not so much the energy resource they sell, as it is how quickly and effectively they will adapt to the new total energy marketplace, and how well they can manage, both strategically and operationally.

Any review of "winners" and "losers" puts one into a slippery area. The politically correct topic of "winners" is opposed by the politically *incorrect* notion of "losers."

But a spade is a spade. There will be losers. Companies will be acquired, some will go bankrupt, and managers will be asked to leave. However, in discussing the winners in this article, we might be able to provide guidance to that "other group."

The top ten categories of winners listed here are ranked in order of importance. My opinion is based on projects in which we have done some directly-related work, on the inputs of industry gurus, on a lot of research, and on some good hard brainstorming within my firm. You will note that each successive winner will exhibit a number—but not all—of the attributes described in the earlier winners.

THE TOP TEN *WINNERS* ARE:

1. The customer
2. Diversified energy holding companies
3. Vertically integrated super ESCOs
4. Diversified energy marketers
5. Customer interface providers
6. Strong niche players
7. Large efficient GENCOs
8. Large EDCOs (with PBRs)
9. Efficient single energy DISCOs (with PBRs)
10. Behind-the-meter-only ESCOs

1. **The customer** is the clear winner. Above all, the customer will have a choice. Choice of service provider, fuel source, products and services and price structure. The customer may not always get the lowest price possible—and, in fact, may even be entirely willing to pay more for the value received. Even if customer class cross-subsidies are unwound, and the transactions costs to smaller customers are high—which might all result in the full benefits of open access not being realized by smaller customers—rates are still likely to be lower, overall, and convenience, choice and service are all bound to be enhanced.

2. **Large, diversified energy holding companies** are the next most likely group of winners. We know who they are. They include the Enrons, the Duke/Pan Energies, the NGCs, and now Coastal Corporation through Engage. They will carry diversified portfolios of fuels and both physical and financial products and services. They will become progressively more asset based, and many will conduct both regulated and non-regulated activities.

They will have the critical mass necessary to hire, challenge and compensate the best of talent, and support the large volumes of physical and financial transactions required to make money off of commodity margins that will become thinner and thinner over time. Their balance sheets will be sound and their pockets deep; their credit ratings will be sufficiently high to give them a real competitive advantage in transactions where only a few basis points will make or break a deal.

The sum total of these attributes will ensure credibility, staying power, market share, and success. Their business will be geographically diverse within North America and also international. Large, diversified energy holding companies will own and operate a variety of subsidiaries, many of which will include some or all of the suborganizational components described below.

3. **Vertically integrated super ESCOs (Energy Service Companies)** are next on the “winners” list. They too will have strong, multi-fuels marketing capabilities, but will differ from diversified holding companies in that they will tend to lack extensive hard energy assets, such as generation, storage and transmission. They will be very delivery and end-use customer-oriented, will offer diversified behind-the-meter consulting, engineering, facilities management and operating services, and will possess an intimate knowledge of gas transportation systems that are relevant to their customers.

While they will of necessity possess energy marketing and trading expertise, their emphasis will be on the offering of total energy solutions. They will exhibit a very high professional and personal service ethic. However, vertically integrated super ESCOs may not have quite the same balance sheet clout, credibility, market diversity and unchallenged international reputation as the large diversified energy holding companies.

4. **Diversified energy marketers** will tend to stick to the marketing of multi-fuel energy commodities and related financial products, and be light on hard assets. They are unlikely to foray past the customer’s meter as will the super ESCOs. They may team with other segments of the industry to offer billing, accounting services, and non-energy products, such as Illinova Power Marketing offers through SourceCom or KN Energy and PacifiCorp are offering through *en*able*, under KN’s Simple Choice brand name. However, with the exception of their relatively light touch behind-the-meter, diversified energy marketers will to a very large degree resemble the vertically integrated super ESCOs.

5. **Customer interface providers** are very narrowly focused on designing and controlling the electronic “ protocols between energy service providers and the ultimate user of the energy. This

supercritical linkage is where the customer needs of “convenience,” “one-stop shopping,” “transparency” and “choice” will be met. These interface services will permit customers to automatically select the energy service source, pay bills, monitor their consumption patterns, access customer and emergency services, access non-energy services and do a wide variety of other things, all of which are at least intended to make the customer’s life a bit easier, if not less expensive.

AT&T and Public Service Electric and Gas, as well as Microsoft and Pacific Corp. are very good, prominent, coast-to-coast examples of the organizational resources which are being directed at this market. Certainly, for all of the previously identified winners to be truly successful, they will need to have access to the customer interface technologies and other capabilities that will be developed and sold by customer interface providers.

6. **Exceptionally strong niche players** will survive and prosper only to the extent they recognize and accept that they are niche players, and plan strategically around that fact. In this arena, big egos need not apply, but smart, hard working management can do very well provided they truly understand their particular niche strengths and doggedly protect their market.

Niche players will tend to be more successful in the retail market where they can capitalize on: (1) their intimacy with the end-use customer; (2) their knowledge of regional, pipeline specific, or grid specific energy delivery systems; (3) their understanding of their particular market and regulatory systems; and (4) their unique and superlative product and service offerings. Although the prospects for growing into a very large company are limited—at least absent some unique product or service monopoly—the margins on revenues for niche players can be very high. And, although the niche player’s product offering, or its market size, may be limited, the selective use of strategic alliances can broaden both offerings and market.

Finally, a successful niche player would be very attractive to an aggressive competitor who is trying to move up on the food chain. If maximization of shareholder value through being acquired is an objective and strategy of smaller firms, being a strong niche player is a virtual guarantee that some vertically integrating energy company—or other new market entrant such as a telecommunications or credit card company—will soon come courting.

7. The key success factors in the **large efficient GENCO (Generating Companies)** segment will include low heat rates, high operating efficiencies, low capital costs and extensive amounts of intelligence regarding transmission system design and operation, market clearing prices, competitor GENCO economics, and the locational value of generation capacity. However, the stark fact of life will be that power will be nothing more than a commodity and winners can enhance their wealth only by being able to produce and transport it as cheaply as possible and by trading it smartly. But, Wall Street types and diversified energy traders and marketers will do the trading most efficiently, so what is left to pure GENCOs is simply producing the commodity at the lowest cost. This will require: (1) the acquisition of existing generating assets—at, of course, very low cost, (2) the consolidation of many GENCOs and/or generating assets to achieve economies of scale and the benefits of asset diversity, and (3) very efficient operations, especially with regard to heat rates and non-fuel operating and maintenance expenses.

8. We begin moving into the realm of “successful survivors” when we talk about **large EDCOs (Energy Distribution Companies) with performance-based rates**. These are energy distribution companies comprised of both pipe and wire, some of which will evolve out of the vertical disintegration of electric utilities and subsequent combination with LDCs. These will be similar in structure to the distribution properties of the traditional “combination utilities,” but they will be markedly different in mission and operating focus. The successful EDCOs will merge horizontally in order to: (1) aggregate rate base, which will continue to be the earnings driver of these natural monopolies; (2) diversify market—over geographic areas, segments, and fuel types; (3) take advantage of the different, but complimentary seasonal and energy demand for natural gas and electricity; and (4) achieve economies of scale. Performance-based rates should provide the better run EDCOs with returns on equity above their less well run brethren.

9. In the case of **efficient single-energy DISCOs (Distribution Companies) with PBRs**, we still remain within the winners circle, but are approaching its periphery rapidly. The success factors here

are explicit in the words “efficient” and “PBR,” and certainly not in the fact that these companies are selling only a “single energy” service. A gas only LDC (Local Distribution Company) will need to be large (to achieve scale economies) and obsessively efficient, with an aggressive regulatory strategy and a good PBR structure, in order to be a successful long-term player. It must also work very closely with natural gas marketers to ensure the greatest possible use of natural gas on its system. If it lets down its guard, the power marketers, multi-fuel marketers and acquisition-minded organizations up the food chain will absolutely consume the single energy DISCO.

10. **Behind-the-Meter only ESCOs** are, in large part, the children of the Demand-Side Management era. Since the recent close of the DSM era, these ESCOs have evolved and diversified in a variety of ways. Some have moved up the food chain and become vertically integrated super ESCOs. Others have stayed behind the meter, specializing in energy facilities engineering and management, energy acquisition planning, utility negotiations and related fields. The competition in this arena has been fierce, and there has been tremendous consolidation and fallout. Some of these ESCOs have been acquired by utilities—for example, New York State Electric and Gas Company’s acquisition of Xenergy—while others have simply gone out of business. But, those with substance have survived, and are now prepared to sell into a market whose demand is expanding rapidly, as major end-users try to figure out how energy industry restructuring will affect both their operations and bottom line.

The key success factor for these ESCOs—aside from their competitive edge and business acumen—will be their objectivity, which is made possible by their independence from any affiliated energy marketer. In our experience, this independence and objectivity is a value attribute for which end users are willing to pay a substantial price premium.

WHAT ABOUT THE “ENDANGERED SPECIES?”

Two rules must be followed to avoid this category. (1) have a vision, check its reality, and go for it; and (2) don’t be small and undiversified, unless you have a very solid niche strategy and oper-

ating culture in place. Those who do not adhere to these rules will be on the endangered species list, at the bottom of the food chain.

The Endangered Species Are:

1. Visionless, reluctant management
2. Utilities which feel they are safe... "at least for now"
3. Small gas- or electric-only DISCOs
4. Weak niche players, especially in the energy marketing arena
5. Small to mid-sized marketers who can't decide between strengthening their niche position or "going for it"

CONCLUSION

"An Optimist Sees An Opportunity in Every Calamity.
A Pessimist Sees a Calamity In Every Opportunity."

—Winston Churchill

Read "Optimist" as "Winner" and "Pessimist" as "Loser" in this statement. The opportunities in the energy industry are legion, and the winners will be those who recognize the fact and are willing to take the actions and suffer the risks necessary to reap the rewards.

"The 90s Decade will be a Nanosecond Culture.
There will be Two Types of Managers—
the Quick and the Dead."

David Vice

*(Retired) Vice Chairman
NORTHERN TELECOM*

ABOUT THE AUTHOR

Richard J. Rudden, president of R.J. Rudden Associates, is a nationally recognized utility expert with more than 20 years of experience in executive, management, technical, and consulting positions within the electric, independent energy and natural gas industries. During the last decade, he has been extensively engaged in a variety of strategic planning, product definition, market analysis, financial analysis, and organizational assignments pertaining to the restruc-

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Prior to founding R.J. Rudden Associates, Inc. in 1981, Mr. Rudden was vice president of Rate and Regulatory Services at Stone & Webster Management Consultants, Inc. and manager of the Rate Design Division at Con Edison. He is a member of the California Competitive Electric Markets Working Group and its market power subgroup. He is also a member of the Rate Committee of the American Gas Association (A.G.A.), is an A.G.A. Financial and Marketing Associate, and has been a faculty member at the A.G.A.'s Advanced Regulatory Seminar at the University of Maryland. A lecturer at numerous other symposia, Mr. Rudden is a member of the Edison Electric Institute, the Corporate Planning Roundtable of Business Economists, and the Association of Energy Service Professionals.