

# P reparing for Financial Restructuring in the Electric Utility Industry

*James W. Harris, President*

*Lawrence J. DeAngelo, Vice President*

*Seneca Financial Group, Inc.*

---

The deregulation of the electric utility industry has been well publicized and much discussed both inside and outside the industry. This deregulation produces the prospect of uncertainty in an industry that has known some level of certainty through the "rate of return" standards imposed by regulators to set rates, and thereby support revenues. Accordingly, the historical concept of "used and useful" will no longer be the determining factor in calculating return.

This change may produce economic dislocation given the capital intensity within the electric utility industry. The Federal Energy Regulatory Commission ("FERC") has clearly indicated that it intends to create a competitive marketplace for electric power. It will accomplish this by allowing any generation source "open access" to transmission lines that have been previously controlled by vertically-integrated utilities.

As a result, certain assets, such as distribution assets and some portion of transmission assets, will continue to be rate of return regulated; however, the remaining electric utility assets will most likely be subject to competitive market returns.

## ELECTRIC UTILITY DEREGULATION AND THE REGULATORY COMPACT

Electric utilities are comprised of three separate but related functions: the generation, transmission, and distribution of electric power.

Based upon the pronouncements to date by many individual states and the FERC, the generation of electric power will be deregulated over the next 12 to 48 months. Transmission of electric power, although more problematic, will likely be deregulated over a longer time frame. Finally, it would appear that retail distribution is not likely to be deregulated in the near future, but may be deregulated over an extended period of time.

By promoting open access to transmission, it would appear that the FERC is attempting to lower electricity prices for most consumers by eliminating the monopoly currently enjoyed by existing distribution companies. In theory, this competitive framework will be fostered by having operators of transmission facilities post standard tariffs and permit open access at those rates.

Currently, there is a wide disparity nationally among electric utilities as to the mix and concentration of individual asset classes, i.e. generation, transmission and distribution. Since transmission and distribution assets will likely be subject to rate of return regulation over the near term, this disparity in asset mix will have implications on the potential assets that an electric utility may have at risk.

Different fuel types and operating performance have created a wide range of rates to consumers. It is this difference which will likely produce significant and long-lasting dislocation among competitors in the industry. This dislocation, to the extent it occurs, will arise as assets that were formerly sheltered in a rate setting environment that *presumed* an economic useful life are subjected to free market competition. Given the capital intensive nature of the electric utility industry and very long lived assets, resource planning has taken a long-term view. The current system has supported investment in power generation assets under the understanding of return based upon little or no financial risk.

At the same time, local and state authorities, with support from federal authorities, have also encouraged the growth of independent power producers. Because many localities had particular resource issues and environmental issues that needed to be addressed, marginal cost was not always the guiding principle in determining the size, fuel type and precise location of a generating facility.

In the airline industry, the shift in regulatory focus forced a shift in competitive emphasis to marginal cost pricing among competitors in order to survive. Because airlines purchased or leased

aircraft which were capital intensive, as rates were deregulated, airlines became fixated upon filling seats to cover these high fixed costs. This in turn led to highly variable fare structures, passenger loyalty promotions such as frequent flier programs, quick abandonment of unprofitable markets, as well as rapid forays into less competitive international markets.

We would expect to see these same strategies employed by electric utilities as competitive responses in a deregulated environment. In fact, many utilities today actively implement ways in which to "serve" their retail customers in other ways, such as security services, energy conservation, energy management and even telephone service. We are also seeing a number of utilities acquiring other utilities in overseas markets.

However, electric utilities have a unique aspect to their history that will become significant in a deregulated environment. Historically, utilities have accessed capital (both debt and equity) under a tacit compact among the regulators, the utility and the investors. This compact established rates of return that were sufficient to attract capital through a revenue mechanism linked to electric rates.

The nature of rate of return regulation and the backstop that is conferred by passing through costs has provided an artificially low cost of capital to utilities. The certainty of cash flows has allowed utilities to use much higher levels of debt and preferred stock than industrials to achieve the same bond ratings. Even electric utility equities are perceived to have stable cash flows and hence, higher dividend levels, which have supported valuations in excess of other businesses given the historically low growth prospects of utilities.

### **Governmental Policy, IPPs and Capital Costs**

Another important feature of the electric utility industry is the financing activities of the U.S. government. Since the Depression, the U.S. government has been committed, as a matter of policy, to promoting the growth of electric power throughout the United States. To accomplish this, both the U.S. government and many state governments have encouraged the construction of generation and distribution facilities.

The attraction of environmentally friendly power and the perception of potential power shortages fostered government actions to encourage a wide variety of companies to generate electricity to sell to

electric utilities. One example of such government policy was the Public Utilities Regulatory Policy Act (“PURPA”) of 1978. This legislation mandated that utilities purchase power from these entities under certain conditions.

Developers were able to finance their projects from the revenue streams created by these power purchase agreements. Given the typical strength of an electric utility’s credit rating, these facilities could be leveraged, and in some cases, highly leveraged. The debt burden associated with these power plants would be insupportable without long-term contracts from highly rated utilities, often with generous expense pass through features. In a deregulated environment, these contracts would have to be evaluated similarly to any potential contract that would be put forth by the newly independent utility generator.

## MANAGING THE REALLOCATION OF VALUE

### **Identifying the Value Gap**

We believe the movement to a deregulated system will, over time, create “value gaps” between the implicit market values of electric utility assets and current book values of these assets. Although the impact will be felt initially in the generating class of assets, transmission and distribution assets will not be immune. Thus, the principle challenge for managers of utility assets will be to manage this reallocation process in such a manner to as maximize shareholder wealth without creating undue risk for other stakeholders such as creditors, employees or customers.

Managing this process will not be easy and will not be reduced to a standard solution. Identifying problems and correcting them are a critical function for a management team in this environment. For those managements committed to accepting the inevitability of competitive change, we suggest (i) developing an analytic template which seeks to value each segment of the business on a stand-alone basis, (ii) identifying and isolating issues of structure (both organizational and capital) that will promote or hinder profitability and competitiveness in a deregulated environment, and (iii) creating a strategic program that sets out the key goals and tasks to be accomplished in adapting to the new competitive environment.

### **Assessing the Value Gap**

Each business entity has a unique competitive profile that sets it apart from its competitors. This profile is comprised of items such as customer mix, market area, asset mix and capital structure. In a deregulated environment, each of these areas will be affected in different ways. Understanding the extent and breadth of this impact on each segment of the business will provide an essential underpinning for adopting an effective strategic response.

Unlike airlines, which use capital to acquire and operate highly mobile aircraft, electric utilities use their capital on fixed assets with limited alternative uses. Therefore, airlines can redeploy their assets relatively quickly, while electric utilities have limited flexibility. However, like airlines, competitors will be likely to price their product on a marginal cost basis to spread a high level of fixed costs among more customers.

Understanding how this strategy may impact any given utility involves valuing the utilities' assets on a stand-alone basis. Today, marginal power in selected markets is being priced at approximately 1¢ per kilowatt hour. According to Standard & Poors, the average cost of each kilowatt delivered to a customer varies between 4¢ and 12¢. The disparity between the marginal cost at the generator of the low-cost producer plus anticipated transmission and distribution costs and the current delivered cost to the consumer indicates the magnitude of the potential reallocation of value.

Through an exhaustive assessment of each asset category and each asset within that category, managements can begin to develop a strong sense as to the magnitude of the reallocation of value issue. The approach for valuing these assets should, in our view, be based upon the anticipated marginal cost of power. Since any valuation for financial purposes is subject to many assumptions and judgments, the objectives should be to quantify the potential impact in terms of order of magnitude as opposed to a specific number.

### **Controlling the Value Gap**

Once the order of magnitude has been determined, management should take up the issue of controlling and ultimately reducing the value gap to the maximum extent possible. Management's ability to do this over time will be influenced by many internal and external structural issues.

The internal issues will be comprised of items of organization, such as reporting relationships, functional accountability, employee relationships, and structural design (subsidiaries vs. divisions). The external issues will be comprised of items such as regulatory relationships, legislative relationships, service area and customer demographics. Local economic patterns and competitive issues within the market, as well as nearby market areas will also be important.

Because many of the items listed above have long standing origins, they will be the most difficult to change. However, to assume that they do not matter or can be easily manipulated will be a fatal mistake for many.

Bringing these forces together may be the single most important act a management team can perform for the long-term wealth of shareholders and other constituents in the face of rapid changes. Accomplishing this task will require the objective analysis of each major structural element that needs to be modified in reducing the value gap.

Orchestrating the effective use of these structural elements will provide management with a meaningful strategic and tactical challenge for a prolonged period of time. Without this exercise, however, managements will cede control of their organizational destinies to market forces.

Given the capital intensity that has characterized the utility industry historically, a utility's capital structure will be one of the more important issues to be considered. Traditionally, electric utilities have financed themselves with high levels of debt and preferred stock. For the most part, the debt of public utilities is secured with mortgages on utility property. Indentures covering the issuance of such debt frequently contain contractual obligations with respect to fixed charge coverages, earnings tests, or collateral coverages which, if violated, could precipitate a default which in turn could cause long-term payment obligations to be due and payable in advance of scheduled maturity.

In addition to funded debt obligations, utilities have used several "off-balance sheet" obligations to fund their operations or reduce the costs of operation. Fuel supply contracts are frequently used to insure ready supplies of fuel for generators. Power purchase contracts have been executed for environmental reasons and for assuring regulators and customers that adequate supplies of power will be

available for a given market. Power supply contracts have been entered into to assure a ready source of revenue when the immediate demand for available power may be in doubt. Finally, the sale and leaseback of power generation assets has been used as a source of generating cash.

Each of the items mentioned above comprises, in part, the capital structure of an electric utility. As such, these contractual obligations should be considered along with other important structural issues as part of the analysis of the value gap. Unfortunately, in times of financial stress, many of these financial items may come into conflict with other structural issues.

In December 1995, Standard & Poors conducted a study to determine the impact on utility revenues if customers were to be able to choose their source of power. This study concluded that in a deregulated environment, revenue could decline by \$10 to \$26 billion. Such a decline would cause severe financial strain on many utilities.

In such an environment, managements' and their Board's of Directors take on added responsibilities. As the level of financial stress increases, the obligations expand from the shareholders to other stakeholders, including creditors, suppliers and customers.

In some cases the competing demands of various constituencies can be met through quiet negotiation away from the public. However, as the number of difficult constituencies increases and the level of financial stress increases, there is less likelihood that such a feat can be accomplished without the protection of the bankruptcy court.

### **Bankruptcy as a Survival Strategy**

Already one major utility has proposed to extensively modify its relationships with suppliers and customers under a voluntary approach. In making this proposal, the utility also indicated that if the proposal (or something very similar) were not agreed to, bankruptcy would be likely. However, it seems difficult to justify the potential losses to shareholders without any specific event necessitating a filing. Nevertheless, bankruptcy as a survival strategy will continue to be considered as a rational response in a deregulated environment.

Unfortunately, the track record for successful bankruptcies among public utilities is not very compelling. For the most part, an analysis of the outcomes of utilities filing for the protection of the courts shows that it is more likely for an electric utility to be sold to

a third party than to successfully reorganize. Thus, management should view bankruptcy with trepidation; it is an expensive and uncertain process for modifying creditor claims in light of changed circumstances.

Addressed in this light, bankruptcy becomes a poor choice for a utility management team seeking a panacea. Instead, a management team, having identified a significant value gap, and having limited ability to resolve the structural issues creating the value gap, may decide to use bankruptcy as a tactical tool to reduce their value.

Nevertheless, managements in such situations would be well advised to consider thoroughly all issues pertaining to the successful reorganization of their company. If such consideration produces a limited number of issues that are seemingly intractable in reducing the value gap, a carefully planned strategy using a bankruptcy filing as a tactical means to for gaining agreement may be desirable.

The reason for this is quite simple. Those utilities seeking to use bankruptcy as a tactical response are in all probability those with very difficult regulatory issues and complex contractual obligations. In such cases, proceeding into bankruptcy frequently may produce counter-intuitive results.

Using the bankruptcy court to resolve these types of issues is not particularly useful because the courts have little basis for applying the bankruptcy law in these types of situations. Usually, rejecting an executorial contract can give rise to certain claims subject to offsets and mitigation. If multiple types of contracts are in question, it may prove difficult to devise a common standard by which to measure the economic cost to the debtor.

Achieving rate relief through the bankruptcy courts has proven to be even more problematic since it is not clear that the courts have the power to impose and enforce these types of remedies. The same is true of the labor argument where wholesale rejection of collective bargaining agreements has been made more difficult.

In summary, utility managements who have made an exhaustive evaluation of the asset classes on a market basis and have developed a sizable value gap as a result of that analysis may want to consider bankruptcy as a tool to survive the rigors of deregulation over the long term. However, the tactic is probably best used when one or two structural issues can be clearly isolated as impediments to reducing the value gap.

## Conclusions

Over time, deregulation in the electric utility industry will cause significant economic dislocations. Like the airline industry, the electric utility industry seems to be anticipating these dislocations by consolidating within the sector, acquiring assets outside the United States, and embarking upon internal restructuring programs.

However, given the current "spread" between the marginal price of electric power and delivered rates to consumers in various locales, it seems certain that marginal pricing will drive down revenues just as it did in the airline industry. At the same time, unlike the airline industry, the electric utility industry is highly segmented and only one segment (generation) is likely to be deregulated soon.

Well-managed utilities will gain a better understanding of their prospects by evaluating all segments of their businesses and developing an estimate of their dislocation in a deregulated marketplace. Next, they will set out to identify and mobilize those structural elements which will enable them to close that value gap.

Managements who cannot or will not recognize and deal with these issues because their "franchise" is too important to go down, will be well advised to remember that at one time, the Pan America logo was one of the most recognized trademarks in the world.

---

## ABOUT THE AUTHORS

**Mr. James W. Harris** is president and founder of Seneca. Prior to establishing Seneca in 1993, he was a managing director at Lehman Brothers and head of the Financial Restructuring Group. During Mr. Harris' 10 years with Lehman, he worked closely with clients to raise capital through public and private offerings, advised on M&A engagements and was actively involved in the firm's financial restructuring assignments. Before joining Lehman in 1982, Mr. Harris spent 10 years working for Citibank N.A.'s Institutional Recovery Group as a senior loan officer. Over his 23-year career, Mr. Harris has been involved in numerous transactions. Selected restructuring transactions include Columbia Gas Transmission, Deseret Generation and Transmission, Tucson Electric, Long Island Lighting Company, Allied Department Stores, Texaco, Six Flags Amusement Parks, Sharon Steel and Federated Department Stores.

**Mr. Lawrence J. DeAngelo** was a vice president at Seneca when this article was prepared. He is now with Wachovia (Atlanta branch). Mr. DeAngelo joined Seneca in February 1995 as a vice president. Prior to Joining Seneca, he spent 3 years as an associate in Kidder Peabody's Corporate Finance Department. Mr. DeAngelo has participated in various corporate finance activities, including mergers and acquisitions, divestitures and debt, preferred stock and equity financing. In addition to Mr. DeAngelo's investment banking experience, he worked for two years at Peterson & Co. as a senior consultant.