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The oil, gas & energy sector

SPECIAL REPORT

Refuelling the energy sector

BY COLIN RICHARDSON

M&A: positioning for the future

So far this year, the energy sector as a whole has witnessed $260bn worth of deals, according to Dealogic. Last year, M&A in the oil and gas industry more than doubled in value to $160bn – the highest level since 1998, when Exxon and Mobil merged, BP took over Amoco and Total bought PetroFina. The macroeconomic environment over the last 24 months has been particularly conducive to dealmaking; indeed, Deloitte suggests conditions are the best in 20 years. "Despite a fall-off in oil and gas prices over the last few months, M&A activity in the E&P sector is still relatively busy," says David F. Asmus, a partner at Baker Botts LLP. "There is a vast amount of capital available, both in the form of high profits by E&P companies and in the form of private equity, to fund energy investments. In addition, most participants in the market seem to believe that prices will recover after a temporary dip, as futures prices demonstrate. At present, we do not see a major slowdown in 2007."

Utilities have also been active, with total deal value and volume at record levels. Buoyed by limited supplies and high demand, the sector has seen a spate of attempted mega-mergers. In Europe, Gas Natural and Eon made separate bids for Endesa, and Gaz de France plans to merge with Suez following Enel's hostile bid for Suez. In the US, Duke Energy and Cinergy completed their merger this year, as did MidAmerican Energy and PacifiCorp. Industry professionals expect consolidation to continue across the utilities industry, although there are obvious limits imposed by regulatory concerns over horizontal and vertical market power.

Financial buyers are also driving up deal numbers. Since the profits of utilities companies tend to rise with inflation, they are attractive assets to fund managers. "Smaller companies are declining in numbers as financial buyers continue to make plays for them, which leaves the mid-market abandoned in a no-man's land – where large companies scale up and small companies opt out of independence. With limited options, one of the more attractive avenues is to go private. In the current market, traditional private equity funds have been pre-empted by infrastructure funds, which have a different investment horizon and profile," says Tom Flaherty, a senior vice president in the energy group at Booz Allen Hamilton. In the US, for example, one of the most notable players is Australia's Macquarie Bank, which acquired distribution properties in the UK and is in the process of acquiring Duquesne, a utility located in the US. Macquarie has had success by focusing on one specific element of the value chain and finding targets that are not in volatile segments, have good cash flow characteristics and provide a steady return on earnings. It is also proficient at financially engineering transactions by taking an aspect of the ownership interest and putting it into an income trust to attract a degree of beneficial tax treatment.

Valuations across the energy sector have skyrocketed due to high commodity prices, excess capital and fierce competition among buyers. In the US, the industry is fully valued with a high relative P/E ratio compared to the S&P index on historical terms. A recent study by UK-based corporate advisers Harrison Lovegrove and US research company John S Herold found that executives were willing to pay 54 percent more in North America in 2005 than they were the year before. While high valuations have not inhibited activity levels, they have made the financial dynamics of transactions more tenuous and demanded greater discipline on the part of both strategic buyers and financial sponsors. According to advisers, control premiums have slid from 25-35 percent to around 15 percent this year. Financial buyers have reportedly altered their investment horizon and returns threshold, and no longer target returns percentages in the order of 30-plus or even 20-plus. ■

The desire to acquire

Large scale transactions are chiefly aimed at pursuing partners to differentiate companies from the rest of the market. There is a desire to improve the financial strength of the company, gain operational flexibility, weather market cyclicality, manage ongoing regulatory requirements and meet the needs of consumers. From a financial perspective, companies are striving to maintain their financial quality. They want to bolster credit ratings to achieve a lower cost of capital and access to markets. This is necessary to support the unpredictable capital expenditure requirements impacting this highly regulated and competitive industry.

The ability to combine companies to shrink the cost base and constrain the rate of cost escalation in the future is of greater importance today than in previous years. For US companies, almost 50 percent of non-fuel operations and maintenance expenses are increasing at about 5 percent per year, according to one professional, through a combination of contractual wage and salary arrangements and escalating healthcare and other benefits costs. Companies are also seeking to create additional cash flows to support the expense of infrastructure construction programs.

There is an acceptance that organic growth simply will not provide companies with the level of earnings that the market has come to expect. Currently, the rate of earnings growth hovers at 4-5 percent on average throughout the US industry. But expectations exceed this figure thanks to a handful companies that have achieved growth rates above this level. Finding the means to create new earnings streams is a huge motivator behind current M&A strategies. But acquisition targets that ▸▸

will provide optimal strategic benefits to companies are in short supply. Consequently, in most cases, opportunity trumps strategy. What is available in the market has a larger impact on M&A than the primary strategic direction of acquirers.

M&A is being used to gain market power through diversification and geographical spread, propelled by a need to source and secure power or fuel. This is especially true of emerging markets with high consumption requirements. Halbart Völker, a managing director in the energy group at NIBC, suggests, "National oil companies, such as those of China and India, are actively looking to expand geographically by targeting international companies. Their main objective is security of supply – to obtain improved geographical spread for sourcing hydrocarbons to fuel their booming economy. They also seek access to technological developments by acquiring companies with innovative seismic or deep sea installation skills, for example. These efforts should increase in the years ahead."

Many leading energy executives advocate vertical integration to control all aspects of the sourcing, generation, distribution and commercialisation stages of the energy chain. Vertical mergers allow companies to hedge risk at each stage of the process. When prices at one end of the spectrum are down, it tends to follow that prices at the opposite end are up, so vertical integration allows companies to generate profits irrespective of market forces. But regulators are putting this business model under threat. In Europe, there is a concerted push to deregulate and unbundle vertically integrated energy companies, according to Mr Völker. "A law expected to pass through parliament in the Netherlands in the near future is intended to drive a legal split between the generation, supply and distribution parts of the energy business. If the bill passes it will require integrated companies to demerge their units. The fact is energy remains one of the key securities for economic growth and economic stability – and therefore political stability – so it is not an aspect of the industry that is likely to recede."

Regulation is a key component of both large and small business combinations. National and state governments are particularly proactive when it comes to energy mergers, and the abandonment of attempted deals such as Exelon / PSEG proves the regulatory path is not always smooth. Regulators are closely assessing the benefits that will ultimately be available to customers once a merger is completed. They are acutely focused on these benefits as customers are already hit with high energy prices arising from other external factors, such as rising inflation, spiralling fuel costs, the substantial infrastructure investment requirements of large companies and expenditure surrounding environmental compliance. If a proposed merger may add to the pricing pressures faced by consumers, rather than alleviate them, regulators are likely to take an unfavourable view.

Yet there is a certain co-dependency between regulators and companies. Companies need to achieve many of their objectives through the M&A process, and regulators need to ensure the critical energy industry is well-positioned to service the market in the years ahead. There are many methods by which regulators and companies can balance both short and long term outcomes. For example, transaction benefits can be distributed to customers in many ways. Apart from reducing prices, for example, companies can redeploy cost savings back into the network or infrastructure to improve reliability.

In the M&A approval process, companies and regulators will have to manage their co-dependency to ensure a balance between financial stability for the merged company on one hand, and ongoing benefits for customers on the other. By applying best practices at the operating level to the acquired company, a utility should be able to achieve significant productivity gains, for example. During the regulatory filing process in the US, companies often cite expected savings of around 5-10 percent of relevant operation and maintenance expenses. One concern surrounding energy acquisitions, however, is the ability to successfully extract the savings possible from the target company post acquisition. If companies can demonstrate a capacity to generate savings more consistently, regulators may be encouraged to approve and support a higher number of their proposed transactions.

In the past, companies often viewed the regulatory approval process as a battle within a larger war. "The objective was to have the transaction approved and move on relatively unscathed," suggests Mr Flaherty. "But companies are beginning to realise that if a transaction is to be financially successful, a long term view of what regulators require is necessary. Acquirers need to demonstrate that their deals will not destroy shareholder value. They must also assure regulators that they have a long-term, equitable view of how savings and benefits will be distributed to consumers. This mindset extends beyond the skirmish and requires companies to think about their entire M&A campaign." ■

New market entrants

Attracted by the favourable pricing environment and ability to cash out profitably in a high valuation M&A environment, start-ups are appearing with increasing regularity in the energy sector. Despite the dominance of incumbents, these new entrants continue to try their luck in a sector that offers the potential for huge returns. "New entrants have lately been either the smaller companies testing the international arena by pursuing selected offerings, or the affiliates of national oil companies that seem to pursue every major project lest they miss out on world class opportunities," according to Allen C. Barron, president of Ralph E. Davis Associates, Inc. "The former group increases competition among established players in the more moderate situations, while the latter group tends to drive up the cost of operations by pushing the limits of traditional financial measures."

These smaller entrants are prepared to lower their profit margins to gain market share and undermine their rivals. Since they lack the resources of more established companies, start-ups also try to gain an advantage by focusing on only a few competencies and performing them to a high standard. In this way, companies that can identify a niche core business are often able to exert influence in the market well beyond their size.

But life is not necessarily easy for an energy start-up. Apart from the US E&P and renewables segments, where a substantial amount of ►►

money seems to be available, new entrants in other segments are finding it tough to raise capital. A number of investors have realised that the energy industry requires sizeable long-term investment to support future projects such as deep-water exploration, gas-to-liquid infrastructure and next-generation combined-cycle gas turbine. As a result, those investors looking for a quick yield are turning to other sectors. And those investors that do remain committed to energy are taking a cautious approach. Geopolitical risk, financial expectations, environmental regulations and increased competition make savvy investors unwilling to support more speculative start-ups, and these companies are losing out to rivals with a proven track records and milestone achievements.

Compliance costs also affect smaller companies in the energy sector. In the US oil and gas sector, reserves reporting, decommissioning, customer account collection difficulties, energy trading, taxation and carbon allowances are all impacted by Sarbanes-Oxley. The infrastructure necessary to meet such regulatory demands is a significant expense. "Smaller companies competing on a regional basis are being hindered by the increased cost of compliance," says Mr Barron. "Larger companies are including the increasing cost into their overall project requirements, so that it becomes a smaller percentage of the overall burden. The result to both is a drain on people resources and an increase in the overall cost of operations. Due to such costs, private companies have elected not to enter the public market to raise funds." However, if a company can implement compliance systems and put them firmly in place across their operations, follow-on compliance costs do drop significantly and good business practice usually becomes ingrained in a company's approach to reporting. ■

Operational challenges

The unpredictable peaks and troughs in commodity prices are forcing market leaders to work harder to maintain their dominance. By utilising effective scenario planning and other processes, companies are able to insulate themselves against potential shocks. According to Paul O'Rourke, co-head of the Energy & Environmental Practice at CRA International, it will be critical over the next five years for companies to manage financial and operational risk effectively. "Leading operators have realised they can create a tremendous amount of value simply by utilising the sophistication of the market through risk trading and creative risk management, for example. They need to understand the marketplace and transformational requirements to drive best practices. It is also necessary to optimise margins through asset management rather than simply trying to preserve the life of their assets. The future pace setters in oil, gas and utilities will have mastered these elements of the business."

But the hedging issue is viewed by some as a two-edged sword. Afonso Reis e Sousa, a director at Taylor-DeJongh, believes the most visible impact on increased volatility in the energy markets is the growth of the hedging and derivatives markets. "Increasingly sophisticated instruments are being offered to provide security against future price swings, although some observers see this development as a mixed blessing," he says. "On one hand, the growth of hedging products allows industry participants to more accurately forecast future cashflows, albeit at a price. On the other hand, it has been argued that increased levels of speculative trading in hedging and derivative products (as well as in primary markets) have actually amplified price volatility."

As energy companies focus on value creation at the operational level, it seems the industry has moved a long way from its traditional methods. Pressures that were non-existent years ago have sprung up to challenge production processes and supply lines. Bottlenecks in refining capacity, access to new energy sources in challenging regions and the development of alternative fuels to combat the decline of existing sources are now a priority in boardrooms. Ultimately, what distinguishes successful companies from the rest of the pack is an ability to adapt earlier and more intelligently than competitors to new situations presented by the market.

One example of the shifting approach in the US is the increasing focus on asset management. This involves operating an asset, such as a power plant, in such a way as to maximise margins rather than to optimise the expected life of the asset. "Over the past 50 years, companies put an emphasis on extending the life of an asset, with the intention of lengthening the time in which profits could be extracted from it," suggests Mr O'Rourke. "In the past five years, however, there has been a movement towards maximising the profit margin and worrying less about how long a plant will last. When companies consider a potential acquisition, this theory now comes into play. Acquirers must assess how well a target manages its assets and whether the acquirer might be able to optimise the inherent margins further."

Global expansion also seems to be a major concern. Large incumbents are desperate to grow. However, it is becoming more difficult for companies to extend their geographical footprint. The power of state monopolies is particularly acute when companies venture across borders into developing areas of the world, such as South East Asia, West Africa and Brazil. Problems apply not just to E&P companies but also to the services companies that support them. Across the board, these companies must comply with local content regulation, tax rulings, royalties, and so on. Presumably companies will continue to face these hurdles as some of the largest new reserves are located in the world's most difficult regions.

A number of large energy producers such as Russia and Venezuela also seem to be deliberately sealing their borders to foreign investment. Russian energy group Gazprom, for example, recently announced it would develop the 'supergiant' Shtokman gas field in the Arctic by itself – Western companies would not be welcome. European governments have been highly protective of their utilities assets. France and Spain both sought to block foreign takeovers of domestic companies this year. ▸▸

Such difficult conditions have resulted in a 'flight to quality', according to Mr Asmus, whereby companies retreat from countries they perceive as having high risk political environments. "With forced contract renegotiation or expropriations in Venezuela, Bolivia and Ecuador, South America, with the notable exception of Colombia, seems to have fallen from favour," he says. "The notable recent gainer, due to these difficulties, has been North America, where high prices and relative political stability have encouraged a new waive of investment by US and Canadian companies as well as foreign investors." Indeed, the Alberta oil sands in Canada are particularly attractive to companies and investors due to the favourable tax regime and politically stable environment. According to a study by CIBC World Markets, Canadian oil sands are expected to become the single biggest contributor to incremental global supply by 2010.

But there are opportunities for companies that wish to make inroads into challenging regions, as long as they enter with the right approach. When operating abroad, one of the first steps companies need to take is to contribute generously to local economies. Foreign companies must be viewed as an investor in that country, not only by paying taxes but also through sideline investments for the greater good. Companies also need to ensure they build a political network and refine their lobbying capacity. This allows them to gain an understanding of the political climate, and then attempt to influence it. ■

Technology and renewables

Many energy companies are almost net debt free at present. As a result, they are looking for capital instruments to optimise the balance sheet, such as investing in additional capacity or executing an acquisition. Since acquisitions have in some cases proved difficult to source and close at reasonable prices, a number of companies have raised hybrid capital instruments and utilised them for stock buy backs. But others are using capital to maintain and improve current energy supplies. Persistent concerns over limited energy supplies compel companies to strive for effective and efficient production methods, and R&D is being carried out on clean fuels and renewable energies as regulators tighten the noose over environmental concerns. In the oil & gas sector, for example, technological developments include techniques to extract more oil economically from mature reserves.

Renewable energy is also climbing the operational agenda and playing a notable part in capital deployment. There is a push to limit reliance on existing fuel sources like coal and gas, and to make these more clean and efficient going forward. Renewables are an important solution in this context. "Technological advancement in the energy sector will be most focused on the renewables sector in coming years," says Mr Reis e Sousa. "Continued advancements in renewables technology will be required to allow the industry to compete effectively against traditional fuels, particularly if global oil and gas prices were to fall in the future." The impetus to investigate unconventional energy sources is clearly growing. Recently, the International Energy Agency predicted that wind power will be the second largest renewable source of electricity in 2030, after hydroelectricity.

The integrated gasification combined cycle (IGCC) process also merits plenty of investment, particularly in the United States. IGCC, which basically involves converting coal to a gas then running it through a turbine, will affect the worldwide power industry and could play a huge role in replacing regular coal combustion. Oil majors and utilities are spending millions on this technology as the US looks ahead to complying with pollution regulations. Photovoltaic technology is another rising addition to the renewables portfolio. Today, the US has roughly 85 megawatts of interconnected photovoltaic, which is a tiny part of the total installed capacity in the US, according to Mr O'Rourke. But many expect this technology to grow rapidly over the next five years. Although it will not replace conventional technologies, photovoltaic is set to become an important alternative.

Industry experts are concerned that regulations may be outpacing the practical development of renewables, however. Regulators continue to increase the renewable portfolio standards (RPS) they place on companies, in some cases requiring the entire energy portfolio of companies to comprise 20-25 percent renewables. But regulators seem unaware of the implications of these imperatives, since most technologies, such as solar photovoltaic and biomass, while advancing, are still underdeveloped and some way from commercial application. Also, certain infrastructure for transmission or delivery must be in place before renewable resources can be leveraged, much of which is not widely available.

Yet the move towards renewables will not fade, and technology will continue to change the way companies view their future network. This is having an identifiable impact on M&A strategies. Companies are eager to obtain new technology, such IGCC, and the superior skills and operations associated with it. But as a company pushes its operations towards the 'efficient frontier', it is troubled by the nature of that frontier, which is either in a current state of flux or may change in the future. This clearly affects target identification for acquisitions, as companies must take a gamble on the technologies they believe will strengthen their position in a market that is quickly altering its shape. ■

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M&A trends: swirling winds

BY TOM FLAHERTY

Expectations have run high for over a decade that the promised massive fusion of the US utility industry would eventually emerge. Pundits have regularly predicted that a sweeping consolidation of this fragmented sector would not only unlock hidden value for customers and reward shareholders, but also position the successor company for a more certain future in a less predictable world.

Realities have fallen short of expectations, however, as the anticipated wave of strategically driven transactions crested well before reaching full force. Lately, a renewed interest has arisen within the industry to again pursue strategic combinations – this time with an eye toward building a stronger enterprise capable of achieving financial flexibility and market dexterity. Has the foreseen final chapter of consolidation really begun to play out, or is this simply another step in the direction of piece-meal aggregation that has characterised the sector?

Changing motivations

While the level of merger and acquisition interest is indeed on the upswing, it is again more measured than frantic. It is clear, however, that the 'third wave' of transactions has begun among US utilities. Company managements are re-examining their financial and competitive postures and concluding that combinations yield the bulk and flexibility necessary to weather the ratcheting demands upon the business.

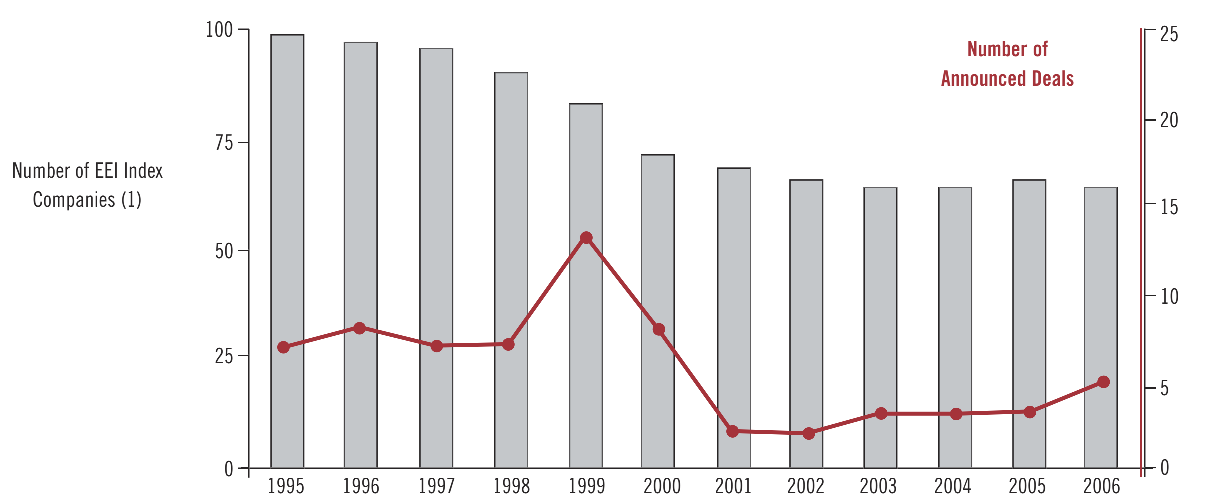
Given the fragmentation of the utility industry in the US, any trend in consolidation will seem mild relative to the number of stand-alone companies that populate the sector. By any standard, two surges in consolidation have already been witnessed – in 1995-1996 and 1999 (*see Figure 1*). The first wave of transactions reflected a response to the deregulation movement and recognition that companies were unprepared for or lacked capability to either thrive or survive in that world. This was generally a sellers' market where smaller entities received large control premiums for the privilege of being absorbed. Where mergers occurred, the middle market sought a similarly sized partner to create greater competitive scale and the promise of survival.

Several years later, the second wave reflected a recognition that to succeed in a market that had turned into a frenzy of merchant generation and trading-based 'growth stories', additional skills and assets would be necessary to succeed in that environment. This market contained more mergers-of-equals with lower premiums and a focus on building a more competitive enterprise, both financially and strategically.

The current cycle of transactions being contemplated and executed carry different characteristics than those that preceded it. With the imminent new build cycle in view for generating capacity, mandated environmental and expanded transmission, companies fear that complying with these requirements requires greater financial capacity than most companies can muster. Further, it is believed that constraint of escalating operating costs can be best accomplished through inorganically driven operational alignment and business integration. This next wave of transactions will thus be structured around moderate premiums and focus on building the strength of the combined, and hence its flexibility.

Regardless of the vintage of the prior transactions, the question remains whether shareholder value is truly being created, or at least preserved. Have expected synergies been realised? Our direct experience affirms this result and points to companies actually being able to surpass their

Figure 1: US Power Sector Transactions



Sources: Edison Electric Institute; Mergerstat

(1) The companies were members of EEI's energy utilities index and have since been reduced by merger activity

expectations and thus create value. More importantly, have transactions actually resulted in discernable shareholder value? To this question, the answer is – that depends.

The extended approval process in the US complicates the measurement of shareholder value along traditional metrics. With this elongated period comes unexpected externalities related to interest rates, fuel prices, and of course, regulatory decisions. These 'events' impact the static measurement of value creation and necessitate careful analysis of this issue. Where control premiums were low and regulatory complications were limited, the ability to create incremental value is enhanced. Where companies experienced less favourable regulatory outcomes and paid towards the upper end of a reasonable range, value creation is hard to discern.

Fitting the future

While each transaction will be constructed with a distinctive style, companies considering combination in this 'third wave' of consolidation will need to embrace several key principles that determine relative transaction success:

- *Recognise the landscape:* With the current concerns of regulators focused on security of supply, reliability of the infrastructure and cost of product, future transactions are provided a positive backdrop for positioning the combination. Leveraging this platform to communicate rationale and benefits in both strategic and customer terms responds directly to stakeholder needs.
- *Seize the moment:* Simply integrating the businesses is tablestakes in any transaction. Successful combinations will think aggressively about using the combination to reshape the business model and unlock additional value well beyond that initially identified. Mergers provide the necessary catalyst to propel the organisation forward when prevailing sentiment is to keep disruption to a minimum.
- *Preserve the value:* The path to transaction success goes through state capitals in the US where regulators are focused on capturing meaningful benefits for customers. Smart companies will construct a framework that provides near-term certainty over the level of customer merger benefits while creating a long-term model for continuing value sharing that doesn't ignore the contribution and risks that shareholders have borne.
- *Sell the story:* An inability to make the case and excite the financial community about transaction rationale and future management intentions has hampered many deals from gaining positive market reaction. And, in an environment of prevailing market scepticism, investors are already predisposed to think narrowly about merger success. Painting the picture in clear colour and demonstrating management commitment to achieve identifiable results can then become a self-fulfilling prophecy rather than only rhetoric.
- *Execute with precision:* The principal failing of many transactions is an inability of management to perform. Mergers are too often under-appreciated for the level of complexity involved and rigor required. Formulating a well-crafted blueprint for action allows management to follow a defined path to a desired end. More importantly, recognising that each option and milestone require specific consideration enables management to provide context to decision-making.

Pressure continues to mount on industry executives to successfully complete initiated transactions. With the recent termination of two mega-mergers in the US, conventional wisdom suggests that utility mergers may simply be too difficult to accomplish in today's world. Correspondingly, the challenges to US utilities to successfully pursue a massive build-out program, constrain operating costs and deliver attractive financial performance have never been more pronounced. In this context, consolidation is likely to become more of an inevitability to meet these challenges. The 'third wave' has indeed begun, yet how it proceeds is no more certain than its two predecessor cycles. ■

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Global utilities investment trends

BY DANIEL I. BLANCHARD AND ROMAN CHEUNG

The global power utility sector landscape has witnessed a significant shift in recent years. The global players of the 1990s have scaled back their far reaching portfolios and have re-directed capital toward creating larger regional footprints. M&A activity has grown sharply in America and Europe over the past five years, while significant organic growth is occurring across Asia and the MENA region. Each of these regions has unique factors driving sector activity and unique barriers to continued development. Overall, however, sector reform measures and regional consolidation have driven recent trends.

North America

The past two years have seen a sharp rise in the number and size of M&A transactions within the US power sector. The industry has recovered from the excesses of the 1990s: companies have sold off non-core assets and exited unprofitable markets, balance sheets have been restored, and utilities are now looking to employ surplus cash. Last year saw announcements of a number of multi-billion dollar transactions including the mergers of Exelon with PSEG, Duke Energy and Cinergy, MidAmerican with PacifiCorp and FPL Group with Constellation. This trend however has not been trouble free; public opposition and regulatory uncertainty have led very recently to the cancellation of both the Exelon/PSEG and FPL/Constellation mergers.

Another key driver of M&A activities has been the repeal in early 2006 of the Public Utility Holding Company Act (PUHCA) of 1935. The move has reduced barriers to the acquisition of non-contiguous assets and simplified approval processes, which has attracted new capital and further spurred consolidation. Thus far in 2006 there have been more than ten deals of greater than $500m, valued altogether at over $17bn. Given the industry size and the number of local and regional utilities, the outlook for continued consolidation remains strong.

Latin America

Power sector reform throughout much of Latin America has moved slowly. Politics and the difficulties of subsidy reduction remain as serious challenges. Power demand growth forecasts across the region however are strong, in particular as many countries seek to revive economic growth. There are even fears that some markets could face serious power blackouts if the sector does not attract significant new investment.

Europe

Europe has been the most active region globally in terms the size and value of transactions over the past two years. EU-mandated deregulation is driving acquisition activity, notably as the mid-2007 target for full sector opening approaches. Aggregate transactions of $100bn in 2005 tripled that of 2004 and average deal sizes doubled to nearly $500m as national utilities attempt to become regional giants. Some of the largest proposals, however, are being catalysed – and challenged – by nationalist protectionist tendencies. For example, the proposed merger of French Suez and Gaz de France was spurred by a cross-border bid for French Suez from Enel of Italy. The proposed merger of Endesa and Gas Natural of Spain has been stymied be a competing bid for Endesa from Germany's E.On. These have set off intense national debates and have kept EU competition regulators busy. Further east, privatisation efforts in the FSU states are being driven by EU accession targets, and in Russia, state power monopoly RAO-UES is being reorganised in accordance with planned full market liberalization by 2009.

Investors are finding strong growth and reliable return opportunities across the global utilities sectors; liberalised capital markets, the emergence of private equity and evolving regulatory regimes should continue to benefit the sector.

Middle East and North Africa

The landscape for power development in the MENA region is characterised by rapid population and power demand growth, large state ownership, and significant price subsidisation. Strong petroleum pricing is providing sovereigns with capital to develop needed infrastructure, and piecemeal efforts at privatisation and economic incentives have spurred private investment. Large government financed projects under development include the $3bn GCC Power Grid which aims to build interconnected transmission between the GCC countries, and the Dolphin gas pipeline project which will deliver natural gas from Qatar to the UAE, Oman and Pakistan. The most significant private capital has been directed toward independent water and power project (IWPP) deals. Examples include bids by Suez Tractebel and Marubeni for IWPP projects in Oman, and by an international consortium on a $3bn IWPP project in Saudi Arabia. As well, Qatar recently awarded a 40 percent stake in a 2,000 MW power plant to Marubeni for $2.3bn, and the UAE has recently called for bids on a number of power projects.

Asia Pacific

The total value of power sector deals in Asia rose to over $15bn in 2005 from $6bn in 2003. The largest transactions have involved the $1.9bn takeover by two Indian companies of the previously Enron-owned Dabhol assets, and the $1.6bn purchase by Hong Kong's CLP holdings of SPI Australia's power assets. Over the past couple years significant new capital has been raised via IPOs in Singapore and Hong Kong, and through Australian infrastructure funds active in the region. Australia has witnessed sector consolidation as natural gas retailer Alinta recently won approval for its $6.8bn purchase of the country's largest power utility (AGL Energy). While India and China are the two fastest growing markets in Asia, investment opportunities are limited by many of the same challenges faced in the MENA region, and the majority of investment under way is largely funded by state owned entities.

Conclusion

The frenzy of private investment in emerging market power utilities of the 1990s has tapered off. Capital is now being redirected to the creation of larger regional utilities, notably in Europe and North America. Regulatory environments have supported and should continue to sustain these trends. Strong demand growth across the MENA region is demanding significant investment, much of this supported by government budgets and high oil prices, with private capital being drawn in selectively on a project basis. Asia is seeing both M&A and greenfield investment. Investors are finding strong growth and reliable return opportunities across the global utilities sectors; liberalised capital markets, the emergence of private equity and evolving regulatory regimes should continue to benefit the sector. ■

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The quest for bargaining power in the gas chain

BY OTTO WATERLANDER

Regulators in Europe are driving the liberalisation process and desire more liquid gas markets. A lack of liquidity and presumed competition is seen as an obstacle to new entrants, customer switching and lower prices. One of the main barriers to market liquidity is the practice of long term contracting, and European Commissioner Kroes has expressed her desire to end such practices. Whether she will succeed in the local market is highly questionable – and she has even less chance of effecting change beyond European borders, which falls outside her jurisdiction. As a consequence, most import contracts are vulnerable to the forces of supply and demand rather than regulatory influence. It will be interesting to see if market forces can deliver the desired market liquidity for the benefit of both suppliers and their customers.

At the turn of the millennium, an important contract was signed to supply gas into China on cost based terms. It was a landmark deal that broke away from the predominant oil-indexed contracting. Since then the Chinese have ventured around the world hoping to repeat their Guandong supply deal. But new contracts were recently announced in which Sakhalin and Malaysia would supply China on market terms. Do these contracts signal a return to traditional contracting practices? Before we can analyse the forces that will craft future supply and demand relationships, we need to examine existing market forces.

Gas is available in abundance around the world. Technological progress and project scale have reduced the expense of producing LNG, while the cost of pipeline supplies is rising since gas must be shipped over increasingly long distances. The spread between cost and market prices for both LNG and LDPG have become similar, which means developers can now turn to either resource on a cost basis. Assuming the gas transport distance is in excess of 3000km, the landed cost of gas is estimated at around $4/mmbtu versus market prices that are almost double that level. Consequently, economic reserves have almost doubled to 180TCM or over 60 years of today's worldwide consumption.

While some professionals believe the emergence of LNG will increase competition and stimulate gas to gas competition, it is unclear why suppliers would change contract terms, taking on more volume and price risks for equal or lower prices. The high capital requirement, funded partly through external financing, demands careful management of time, risk and capital deployment along the supply chain. In addition, a large share of potential gas supplies are controlled by incumbent suppliers already involved in traditional contracting practices that have served them well. The notion of a vastly expanded gas development activity base is questionable, particularly in terms of available skills, so projects will continue to compete with each other for markets.

But could all this change? The global converging market may bring about two new market forces. Firstly, market definitions will expand with a shifting global supply/demand balance. Whereas most of the gas today is traded within distinct markets (net trade between Middle East/Asia, Europe/Africa and the Americas is less than 1 percent), the future market is likely to see inter-regional trade of around 10 percent. The world has expanded for suppliers and their customers seeking to open alternative supply routes. Considering long term price trends and transport differentials between alternative supply routes, the 'new deal' will involve a more fundamental review of netbacks.

Secondly, converging markets will open up arbitrage opportunities as global markets become more integrated. Oil prices in each market are an important driver of current market prices. In the Asian and European markets, this link is evident in the form of direct price indexations. In the US, forces of supply and demand are more prominent, so oil prices are more independent and therefore volatile. Yet prices in all three markets fluctuate at different levels. Although we may experience price convergence between markets over time, substantial price differences may invite opportunistic arbitrage plays.

The markets of Iran and Qatar are also of interest. Both have abundant reserves compared to what has been developed there to date. They may well consider a different volume/margin trade off than players like Russia, which has a substantial share in the current trade. Russia would not be easily persuaded to trade off more volume for a lower margin or a higher risk proposition, for example. Of course, smaller newcomers in the global gas trade, such as Nigeria or the UAE, may face similar choices as Iran, but their influence will probably be confined to individual deals with customers.

Emerging suppliers to the global gas market may seek to benefit from arbitrage opportunities between continents. They would prefer the flexibility to deliver gas to these markets with the highest netbacks. They therefore need customers who are willing and able to accept some level of interruption in their gas supplies. Consequently, these customers have an active role to play in managing interruptions, perhaps encouraging higher storage volumes or alternative energy supplies. In their negotiations with suppliers, these customers would naturally demand a share of the upside in returns, maybe through a lower base price or limited volume commitments.

In summary, gas suppliers may well continue to seek to secure customer demand upfront in order to justify their projects, reduce a project's volume risks and enable financing and project development. On the other hand, customers need suppliers willing to structure their gas flows in such a way as to include them. While there may be more gas suppliers with whom to negotiate, competition for supply has also increased dramatically. Going forward, both gas suppliers and their customers are advised to carefully consider the bargaining power they can bring to the table. It may well turn out to be a market evolution instead of a revolution. ■

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