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Market forces in the energy & utilities sector

BY MARK WILLIAMS

SPECIAL REPORT

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Although, energy prices are up and global demand is soaring, the utilities sector continues to suffer an overhang from the bursting of the 1990's bubble. Shackled by financial and environmental regulations, beset by fierce competition for limited assets and resources, and fraught with geopolitical risks, this remains one of the few energy sectors where the investment community is taking a cautious approach. Even top financial performance and a sound track record, it seems, do not necessarily make these companies safe bets.

Boardroom concerns

As populations continue to grow and as emerging markets mature, the world's people will demand more energy. This appetite will burgeon even as current resources diminish and the difficulty and expense of meeting energy needs escalate. With this is mind, it comes as no surprise that energy and utilities companies are increasingly concerned with security of supply issues. "Security of supply will always remain a key issue, not only for executives but also for governments, policy makers and politicians," says Sohail Barkatali, a partner at Berwin Leighton Paisner. "The energy sector forms the backbone of every single economy in the world and there exists a delicate balance and interdependency between different areas of the energy markets. For example, an increase in the price of natural gas can significantly drive up the price of electricity which in turn (if unchecked) would drive up the price of goods and services available in the economy with the result that, at the margins, consumers would begin to seek alternative ways of supplementing their energy requirements."

Managing the risk of losing access to a consistent energy supply has become an area of focus for utilities executives. Such risk cannot be averted, only managed. The ongoing globalisation of trade will expose the world to greater levels of supply risk as national consumption levels expand and existing supply lines stretch to accommodate them. According to Allen C. Barron, President of Ralph E. Davis Associates, for companies of considerable size, managing risk can become a full time activity requiring a number of simultaneous strategies. "Securing supplies of energy with contractual commitments with suppliers of established credit, hedging supply to accommodate price uncertainties and seeking alternative supply sources are all necessary actions in an effort to mitigate risk," he says.

Embattled by industry forces and increasing competition, market leaders in the energy industry are taking a proactive approach to navigating their sector's many pitfalls.

One method that companies are using to reduce their reliance on traditional energy sources like coal and gas is investing in renewables. Alternative sources are playing an increasing role in worldwide energy production. As an example, the International Energy Agency predicts that wind power will be the second-largest renewable source of electricity in 2030, after hydroelectricity. However, experts do not expect the share of renewable energy as a portion of overall energy sources to change dramatically in the foreseeable future. Hampered by service costs and reliability issues, the slow but steady persistence of renewable technologies will continue but without a major impact. "Integrated oil companies are participating in this sector, either through production of wind, solar, biomass or through other forms of renewable energy projects. But while there are credits and tax benefits associated with renewable energy, these sources cannot replace fossil units. Rather, they enhance the diversification matrix of utility supply and its delivery to customers," says Terry Newendorp, Chairman & CEO of Taylor-DeJongh.

Operational issues and competitive threats

Embattled by industry forces and increasing competition, market leaders in the energy industry are taking a proactive approach to navigating their sector's many pitfalls. The guiding principle, it seems, is to be prepared. "The prevalent theme among industry leaders is risk management and appropriate controls, and a razor sharp focus on market events and the ability to adjust and modify strategic initiatives to these events. Market leaders maintain a focused approach to efficient deployment of capital and resources. While certain sectors fell on hard times due to market dislocations and subsequent legislative actions, today's business leaders were not overly exposed to these events," says Mr Newendorp. Not only do industry leaders shore themselves up against possible market shocks, they are able to pounce on the opportunities created when less prepared competitors are left stranded. Volatility and uncertainty has led the top companies to reinforce their strengths and squeeze out less capable entrants.

Companies in a good position to control their own destiny in challenging times are those with integrated operational structures, mainly because they can exert some influence over the supply chain and respond most efficiently to any disruptions. While shifting toward specialisation and core focus does benefit companies that can streamline their business, it creates a degree of interdependence that may leave them floundering in a crisis beyond their control. For this reason, and in an attempt to improve profitability, some energy companies prefer the benefits afforded by vertical integration. "Maintaining control over all aspects of the supply, distribution and power generation stages are driving companies to retain ownership to the greatest extent possible," says Mr Barron. But many companies simply do not possess the sheer size needed to operate a vertically integrated structure. These mid-level entities recognise that the challenge of competing with large integrated competitors is too great, and instead are divesting those parts of the business that stretch their resources. This unbundling process frees them up to improve their operations within a niche segment of the supply chain.

Although the sector is crowded with participants, new entrants have identified ways to push their way in at the expense of large companies and smaller established rivals. "New entrants pursue policies which seek to erode established market positions. As a result, they demonstrate a short-term willingness to take a smaller profit share with the aim of gaining market share. Establishment of market share brings with it the opportunity to expand that share and to obtain bigger profits on other ▸▸

(sometimes related) transactions. The competitive edge therefore lies in the extent to which players in the sector are willing to push conventional boundaries for the sake of acquiring market share," says Mr Barkatali. He adds that the key for smaller companies is to differentiate themselves by offering reliability at competitive prices. For many, the best way to do this is to focus on core businesses and core skills, anticipate market growth potential and profitability, realise the existence of niche practices and recognise that different business functions are best carried out by separate and distinct entities.

Attracting financing for future initiatives

Generating capital from investment will be a crucial test for many utilities in coming years. A huge amount of investment is needed to build the energy infrastructure necessary to satisfy the world's existing and developing economies. The International Energy Agency expects that developing countries will absorb about half the anticipated $10 trillion total investment needed for electricity generation, transmission and distribution globally in the years to 2030. Such an overwhelming global demand for energy should have investors clamouring to penetrate the utilities space, particularly new markets. Yet the sector remains overshadowed by the more popular oil industry. Why? The main reason is the constricting regulatory environment in which utilities operate. Current regulations are considered by some to be so pervasive and uncertain that they have turned a sector with exceptional investment opportunities into a minefield.

A 2005 survey by PricewaterhouseCoopers – *Under Pressure* – found that investors consider the regulatory environment to be equally as important as the management team of a utilities company. When assessing the viability of a target, investors are apparently influenced in their deployment decisions by: greater regulatory uncertainty, the regulatory incentive for investment, corporate transparency, improved price environment and focused core business strategies – in that order. Considering that regulations governing the sector are only likely to tighten as the world becomes more reliant on energy supply, the prospect of the industry being free of this burden in the future is highly improbable. Utilities boards are channeling their efforts into meeting regulatory obligations and limiting their company's vulnerability to damaging legal action.

Managing legal risks in a burdensome environment

Regulatory pressures may be the predominant threat to the financial viability of energy and utility companies. It is clear that broad legislative concerns are making investors cautious about the sector, which may harm access to capital in the long-term. On the immediate front, compliance issues have hit hard. The costs associated with Sarbanes-Oxley and new accounting processes are higher than many utilities initially estimated and in some cases have eroded profitability above expectations. But reporting standards and transparency issues are not about to disappear, so companies are well advised not to over-inflate the problems and instead look for the positives. "A great deal of the compliance issues address what may be considered good business practices that were in place but not properly documented. The amount of time and expense to prepare compliance filings should decline once both the regulators and industry become familiar with what really constitutes compliance issues," says Mr Barron.

Environmental regulation is another field of law that brings constant change to the industry. "Environmental regulations and pressures have a considerable impact on energy and utility companies, influencing strategic decisions about how energy companies invest capital," says Mr Newendorp. One of the most prevalent international legislative regimes is the Kyoto Protocol, which is having a profound impact on the way companies manage environmental exposures, according to Mr Newendorp. "Even in non-Kyoto countries such as the US, uncertainty of future carbon tax or some other penalty for GHG emissions, factors into and modifies investment decisions," he says.

Energy companies that operate across several jurisdictions must be conscious of their exposure to the laws in each. When entering foreign jurisdictions, companies are increasingly obliged to tread carefully. They must be mindful of local environments and inhabitants to avoid a backlash. However, even in cases where companies are conscious of their activities and respect regional eco-systems, some countries have been known to take political and financial advantage of lucrative foreign companies on their soil. Advisers suggest that energy companies set up teams dedicated to tracking changes when they are introduced and responding with proactive measures to limit all possible risks.

M&A strategies – a change of direction

2004 was a bumper year for M&A activity involving electric and gas companies, signalling a return to form for an industry that had experienced a previous two year lull. Total deal value for all of 2004 was $121.7bn, up from a paltry $54bn in 2003, according to figures from Dealogic. But 2005 is undoubtedly on course to smash the 2004 record, with $104.2bn already notched up, compared to $68.5bn by this time last year.

Much of the activity has been driven by companies shedding assets that were acquired in the busy years of 2000-2001, each of which recorded in excess of $110bn in deal value. In contrast to many other sectors, a high proportion of companies in the energy and utilities industry seem to be resisting the lure of globalisation and are instead attempting to rationalise their operations to concentrate on dominating domestic and regional markets. "The motivating force for M&A is to obtain a greater part of the market share which, in turn, will result in higher returns. Any assessment of a potential target will look at the existence of common synergies: the extent to which the target company has a niche or market share or skill that when integrated with the acquiring company will strengthen, supplement or in some cases, compliment the core business of the acquiring company," says Mr Barkatali.

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But despite the stellar deal figures for 2005, some advisers believe that certain factors are still holding back M&A in the sector. One is the high valuations for energy companies, owing mainly to commodity prices for energy products and the influx of investors looking to grab a piece of the sector. Companies on the block are taking advantage of the current imbalance whenever possible. "Aggressive buyers are having to pay more for resources in the ground and look at longer payback times for recovering the acquisition costs. Non-proven reserves are gaining consideration in the offering price as a method of paying more for properties with greater upside potential. In addition, sellers are selectively keeping properties off the market once an asset valuation reveals a higher than anticipated value for a property, thereby frustrating many buyers wanting to acquire assets in an area of interest," says Mr Barron.

To win assets in this environment, bidders need to be clever in their approach to the acquisition process and bring more to the table, otherwise there is a good chance they will lose out to a competitor. "Heightened competition requires buyers to be more creative in their approach to win competitive bidding, and often provides a competitive advantage to strategic investors or strategically focused fund investors that can realise greater synergies from integration than a non-strategic investor," says Mr Newendorp. This dymamic makes it a tough acquisition environment for financial buyers. Sheldon Adler, a partner at Skadden, Arps, Slate, Meagher & Flom LLP, believes that for all their interest, buyout houses are certainly not as active in the sector as they would like. "Low interest rates have resulted in higher valuations for US public utility and discouraged investment by foreign companies and private equity investors. Investment by potential private equity fund investors has also been discouraged by the failure of state regulators to approve the Unisource and Portland General Electric transactions," he says.

However, a significant regulatory change in the US should facilitate even greater M&A activity. In July 2005, the Public Utility Holding Company Act of 1935 (PUHCA) was repealed and the Energy Policy Act was introduced. The PUHCA was chiefly designed to safeguard the supply of electrical services and prevent abusive practices in the utility industry that threatened the public interest. Powers available to the authorities under the Act included provisions to block mergers and acquisitions and to demand the break-up of particular assets.

Some professionals view the removal of the PUHCA as the possible start of a new era in utilities deal activity. "The repeal of the PUHCA opens the door to transactions and investments that previously either were not possible or practical," says Mr Adler. The Energy Policy Act allows a much wider universe of potential investors and acquirers to enter the sector, including private equity funds, financial institutions, foreign utility companies, and companies that currently are not in the utility sector. It should also stimulate further activity internationally, by lifting regulatory constraints on certain cross-border business combinations.

Further industry consolidation is expected. High prices have ensured that energy companies are not lacking the cash needed to pursue their operational goals. For some, making acquisitions that buttress their core focus will be integral to future success. "For acquisitive companies, the driving force is market power and synergies created through consolidation of various duplicative operating activities. Market consolidation allows these firms to offer a wider range of tailored services and expansion of services to a broader market. The expansion of services is a compelling argument. For example, electric utilities acquisitions offer consolidation of transmission management and asset diversification providing more efficient cost control when delivering electricity to rate-base paying customers," says Mr Newendorp.

M&A will also continue as leading energy and utilities companies attempt to establish a cross-border presence in other markets. Parts of Asia, Eastern Europe and South America are favourable. These regions offer the opportunity for companies to position themselves for future growth in areas of less maturity and greater economic potential, says Mr Barron. But breaking into these markets is not straightforward. Mr Barkatali outlines some issues that companies targeting the Middle East should address. Such points include choosing the right local sponsor for market entry, understanding market dynamics, ensuring that the product offered is the optimal solution for the market, understanding the legal and regulatory framework, appreciating cultural dynamics, offering knowledge transfer to the indigenous workforce and evaluating the wider economic benefits, such as pursuing an IPO on the local stock exchange to stimulate indigenous participation.

When neglected, cultural, economic, political and legal hurdles often stall unprepared companies and can cause significant financial loss. M&A, conducted skillfully and with care, can help alleviate some of the inevitable problems. "Few companies appear capable of a sole entry into a new area particularly in a competitive environment due to the financial risk of failure. M&A activities provide an immediate entry into new geographical regions, while joint venture participation and sharing arrangements provide for a controlled entry with an established player," says Mr Barron.

Energy companies have the potential to tap into rapidly developing markets and also to bolster activities at home. But their ability to do so will be largely defined by their success in overcoming the strong regulatory, investment and competitive market forces acting against them. ■

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