M&A in *European* electricity *markets*

To be viable competitors on the Continent, local and U.S. energy companies are looking to grow through mergers and acquisitions. A successful merger strategy will transform the acquirer into one or more of the new environment's emerging business models—which include Regional Giant, Merchant Powerhouse, or Layer Player. But figuring out which model makes sense in which market isn't obvious or easy

By Eric Ellul and Jo Whitehead

Today's European power industry resembles the Cretaceous period of 65 million years ago, when sudden environmental changes caused the extinction of many species and the evolution of new ones. In Europe, liberalization is today's agent of change. Will traditional power companies follow the path of dinosaurs and become extinct? Or can they evolve to remain the dominant species? While gradual evolution is one strategy for survival, many incumbent utilities are turning to something far more dramatic: mergers and acquisitions (M&A).

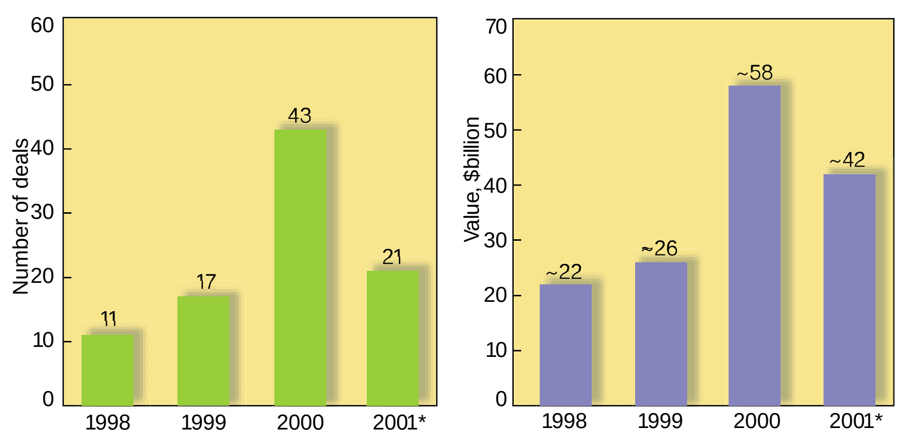
The last three years alone have seen more than $100 billion in M&A transactions (Fig. 1). But there are lessons behind this buying binge. One is that M&A strategies carry their own risks and are hard to execute. Another is that sheer size, by itself, does not guarantee survival. Indeed, if it is done without enough thought, M&A can accelerate rather than forestall extinction.

To pursue an M&A strategy, an energy company must understand which business models are likely to succeed in a competitive environment and which won't. It must also understand how that environment may differ, region by region, market by market—and how a company might have to use more than one model if it plans to operate in different places. Finally, it must understand that the new, liberalizing European environment is itself in flux. Thus, even as a company takes its first step down the M&A road, it must be prepared to alter its course.

Is M&A worth the risk?

So far, the worldwide M&A mania gripping many industries has left critics complaining that such deals are generally overpriced and create no value. They point to studies indicating that 50% of mergers destroy value for the acquirer's shareholders. The Boston Consulting Group's (BCG) own analy-

1. Europe had more than $100 billion in acquisitions over the past three years



Note: comprises all deals involving European companies valued more than $100 million. *January to September 2001 deals

2. Business model description

	Regional Giant	Merchant Powerhouse	Layer Players: Retail	Layer Players: Wires	Layer Players: IPP
Key characteristics	• Vertically integrated • Large market share • Upstream positions in adjacent markets	• Trading and risk management capability • Merchant mentality • Selected upstream and downstream positions	• 10-million-plus customers • Multi-utility • Other cross-sell products	• World-class operations and cost levels • Potentially separated from asset ownership	• Traditional IPP model • PPA contracts to manage risk • World-class operations • Purchasing power
Favored market environment	• Isolated • Illiquid • Benign regulation	• Fragmented upstream and downstream • Vertical disintegration • Overcapacity • Liquid or semi-liquid	Vertical disintegration Liquidity Fragmentation (of competitors)		
Current/ potential candidates	• Most large incumbents in their home markets • Endesa, Iberdrola EDP in Iberia • Vattenfall, Fortum in Scandinavia	• Some new entrants, for example, Mirant • Top four German or Benelux players • Competitors on the fringe, for example, Endesa, Vattenfall, Innogy	• Centrica • RWE • EdF, GdF, Endesa	• 24seven • Many distribution companies	• Existing IPPs • Competitors with strong connections in developing/cash-poor countries

Source: Boston Consulting Group

sis of mergers in the U.S. suggests that this is also true for electric utilities. Significant acquisition premiums in European deals, sometimes in excess of 25%, require substantial synergies to be justified. However, half of the recent acquisitions are in unconnected markets with limited opportunities for cross-selling or economies of scale.

Cynics might ask what synergies justify E.ON's purchase of Powergen? RWE's of Thames Water? Endesa's acquisition of generation businesses in France and Italy, but distribution businesses in the Netherlands? Are companies buying just what is available—for the sake of buying—and not what makes sense?

But for many companies, doing nothing is an even riskier approach. Among the issues inherent in remaining a small player:

- Upstream markets do not respect the national and regional boundaries that defined the old, regulated world. To be an upstream player, you will almost certainly need positions in new markets—and that may well require acquisitions.
- Upstream markets are also likely to be cyclical, so risk needs to be diversified.
- Few companies have a large enough retail market position to survive in the long run. For example, Centrica started with 20 million gas customers in Great Britain, giving it the platform to cross-sell other services and reach some sort of scale in those new businesses. Without M&A, few European competitors will have Centrica's opportunities.
- Wires ownership might be sustainable without M&A. But how many companies want to end up as a pure wires player, stuck within their current geographic boundaries?
- Remaining within one country's boundaries risks exposing a company to one regulatory regime.
- Without mergers, competition in the relatively fragmented European market could be savage. Consolidation leads to more stable pricing, and in commodity businesses—such as electricity and gas—such stability is highly attractive.

For all these reasons, most competitors who want to be a force in the European power industry will need to grow—and in the European environment of slow growth in demand, that means M&A. But they also need to grow "right"—and what is right for each company is unique. What common criteria are there for success?

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What makes an M&A strategy successful?

The key lies in building the right business model for the right environment. The three criteria are that the model (1) makes strategic sense, (2) has a firm financial basis, and (3) includes other options if things don't work out as planned or the business climate changes. Each criterion is critical and worthy of an article in itself. This article focuses primarily on the first one.

For an M&A strategy to make sense, the sum of the merged parts must produce a competitor that is stronger than the individual pieces. Otherwise, the resulting entity is doomed. The merged corporate center will add little value, becoming a mere bureaucracy. The company will underperform its rivals financially. And as it stumbles, its management team will risk losing the confidence of employees, shareholders, and even regulators. Just look at the fate of National Power.

It is, therefore, critical to identify the models that seem likely to have the best chances to succeed in Europe's highly competitive emerging environment. Three main types simplify the inevitably diverse range of options available: the Regional Giant, the Merchant Pow-

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erhouse, and the specialized Layer Player (Fig. 2).

The Regional Giant

This model is the one most likely to succeed soonest. Think of the Regional Giant as you would Stegosaurus—large and armored enough to be daunting to predators, but docile by nature, and content to graze on its home turf. It uses its size and vertical integration to manage risk, control wholesale markets, and beat smaller players on cost and price. Other competitors find it difficult to enter its market because they cannot easily and reliably purchase power, and they lack the scale to build a strong retail position or low cost base. For example, although Spain is one of the more rapidly growing European power markets, Enron has found it hard to build combined-cycle gas-turbine plants in a market with strong incumbent competitors in power and gas. BP was able to secure a project, but had to include the number two player, Iberdrola, in the consortium.

This model thrives in isolated, illiquid markets. Illiquidity provides benefits to vertical integration, which further constrains liquidity, and so on. The starting position for most European power markets fits this description well. Gas markets are generally illiquid, favoring strong power generators. There has been further consolidation in Germany and vertical re-integration in Great Britain, suggesting that prospects for this business model are good.

Two things threaten the Regional Giant: fragmentation and overcapacity. Fragmentation allows the development of other business models. For example, the U.S. upstream and downstream markets are in general quite fragmented, and power and gas traders have developed rapidly at the expense of incumbents. While fragmentation may not occur on its own, it might happen if regulators seek more competition—as in Italy, where ENEL is in the process of being broken up.

The other threat, overcapacity, typically allows new entrants to cut price by sourcing from underused plants at marginal costs. This undermines the incumbent, which would lose too much if it matched the cuts. This is what happened, for example, in the U.S. gas business in the 1980s. As a result, new entrants were able to build significant market share.

Which companies should pursue the Regional Giant model? In Europe, the model is most suited to isolated markets, like Iberia, Great Britain, and Scandinavia, where a regional fortress can be well defended. The extent to which this can be done depends not just on strategic choice, but also on the willingness of regulators to permit the development of large, vertically integrated power companies. In fact, most major incumbents throughout Europe will initially try to become giants in their home markets. From Spain and France to Germany and Scandinavia, they are building from a strong starting position.

To pursue this model, and thus defend the home turf, a company may sometimes need to make only small "rollup" acquisitions and take upstream positions in adjacent markets. For example, Vattenfall is building a position in and around Sweden, acquiring HEW in the process. Electricité de France (EdF) has a share in EnBW in Germany, London Electricity in Great Britain, HidroCantábrico in Spain, and Montedison in Italy. A few competitors, with sufficiently deep pockets, may seek to become Regional Giants in markets other than their own. EdF could try to do this in Great Britain, or E.ON might try the same in Scandinavia, with its acquisition of Sydkraft and Finland's Espoon Sähkö. However, such a strategy runs the risk of putting the newcomer in a weak third or fourth position behind more established local competitors.

As noted, the Regional Giant strategy is already evident in countries where electricity and gas markets are relatively illiquid and the regulatory environment is accommodating. But conditions could change, weakening the giant and/or exposing it to attack from a larger or more nimble predator.

The Merchant Powerhouse

The most frightening model for incumbents is the Merchant Powerhouse. Like a shark, the powerhouse circles its prey, looking for an opportunity. It thrives in fragmented, vertically disintegrated, volatile markets with overcapacity. In such an environment, the Merchant Powerhouse extracts value by squeezing upstream players on price and by arbitraging the attractive margins away from downstream players.

Enron, Dynegy, and Mirant are examples, and all three are seeking to build positions in Europe, where the right environment for their growth is still emerging. Trading in electricity and gas is the core capability of the Merchant Powerhouse.

More often than not, it also invests in focused upstream positions and

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builds a retail position with large customers. That way, the powerhouse is in a better position to arbitrage prices and to offer customers alternative sources of power, from wholesalers or from its own generators. Through better prices or customized offers, it wins market share and weakens the incumbent.

Enron, Mirant, and Dynegy, are seeking to deploy this model in Europe because it is the one they use in the States. But they are not alone. E.ON, for example, already has significant trading experience in different European markets.

Some of the conditions already exist for this species to thrive. A recent report estimates that there is currently 15-20% overcapacity in Western European generation, and demand growth is estimated to be only 1.5% per year. Power generation is increasingly fragmented in some markets, such as Great Britain and Italy, because of regulatory attitudes and actions. Germany has many conditions in place for the Merchant Powerhouse model to succeed: overcapacity, lots of interconnections to alternative sources of gas and power, and some fragmentation. If regulators make stronger attempts to mandate third-party access to transmission grids, and trading liquidity develops, then the environment would favor the Merchant Powerhouse model that much more.

Ironically, the ambitions of some of the Regional Giants might lead to greater fragmentation and overcapacity. For example, EdF, based in France, wants 50% of its business to be international by 2005. This might require building or acquiring stakes in other European countries to set the stage for competing against other Regional Giants. But that may put pressure on EdF to open up its own market, and produce a chain reaction if other incumbents were to retaliate by entering France.

All that said, the conditions needed for Merchant Powerhouses to thrive are not yet ripe. For now, the powerhouses must bide their time.

Which companies might use M&A to pursue this model? New entrants will try, but so far they have found it difficult to build a position in the European club. For example, Enron recently announced plans to cut staff in Europe by 5 to 10%, and Reliant Energy has said it might sell its generation business in the Netherlands. Dynegy has five continental offices but plans to take things slowly.

Some incumbent utilities may try to become Merchant Powerhouses in partnership with accomplished traders. For example, EdF has a joint venture with Louis Dreyfus, and ENEL has one with Mirant. There are two possible approaches. First, an incumbent could try this business model in its home market to defend itself against attackers or to gain market share. E.ON, RWE, or the smaller groups—including EnBW—may partner with a U.S. trader to create a powerful competitor in such an environment.

A second, and more aggressive, M&A strategy would be to become a Merchant Powerhouse and attack other incumbents in their home markets. This would require a mix of chutzpah and skill, and an appetite for risk and resources. Might a mid-sized player in Benelux take on this role? Or could one of the players on the fringe—Endesa, Vattenfall, or Innogy—try it as a way to build a presence in the Franco/German heart of the continent?

The Layer Player

Layer Players focus, like Intel in the computer business, on one part of the value chain. By building scale, focusing on doing one thing very well, and not competing directly with their customers or suppliers, they seek to acquire a strong competitive position. That position can then be leveraged by making it the platform for growth in international markets or entry into other parts of the value chain.

In general, Layer Players do well in deconstructed markets, where there is liquidity, fragmentation, and little vertical integration. They typically also need to start with a very strong position in their part of the value chain. In European power, the best-known example is Centrica and its 20 million gas customers. Centrica was able to combine the liquidity of the wholesale gas, financial services, electricity, and telecommunications markets with the fragmented nature of its competitors in electricity to build a potentially strong position as a retailer of a broad range of services.

But what are the other options for a Layer Player in Europe? By definition, there are a large number of variants. What follows is a brief comparison of three of the more distinctive and significant options: retailers, wires businesses, and independent power producers (IPPs):

■ Retail Layer Players. There are relatively few examples besides Centrica. The problem is the scale required. It takes only a few million customers to have a scale position in billing and customer service. But to defend the customer base and extract the maximum

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value, most retailers need to cross-sell other products—and that may require millions of additional customers. Nonetheless, this business model will emerge where the other retailers are weak and fragmented, and where the wholesale power market has liquidity and overcapacity. A few players certainly have a customer base big enough to develop this model: EdF, GdF, Endesa, and the big German utility groups. RWE is already moving in this direction, although it has a broader, "multi-utility" strategy that also includes distribution. The challenge remains daunting for the rest: acquiring large numbers of customers in one market.

■ Wires Layer Players. A good example of this variant is 24seven, formed from the combination of the wires operations of London Electricity and Eastern Electric. What's interesting is that the latter two companies are subsidiaries of EdF and TXU, two giants certainly able to pursue this model in both Europe and the U.S. The potential for this model increases as liberalization proceeds. As regulators look to put more and more pressure on prices, they will turn from reforming wholesale and retail markets to squeezing the wires business.

Although economies of scale are limited in wires, expertise in wires management—for example, in purchasing or in the use of the Internet to minimize paper transactions and IT costs—might favor such players. Of all the layer plays, this one seems the easiest to nurture. But the regulatory framework to allow it to spread will take time to develop. So consider this as more of an option for the future than a strategy that can be implemented immediately.

■ IPP Layer Players. The independent power producer is one kind of Layer Player that has been around for at least a decade. However, IPPs could have a limited role in Europe. IPPs include International Power, AES, and NRG Energy, all of which have grown in less developed economies, where governments want increased electricity but are short of capital; hence they are prepared to offer IPPs long-term power-purchase agreements (PPAs).

Another type of IPP competes in merchant markets—such as Innogy in Great Britain and Fortum in Finland. Some of these players, including Innogy, aspire to become vertically integrated Regional Giants. Others are simply willing to risk the cyclicality and volatility of power markets—although this requires shareholders with an appetite for risk. For such players, M&A may help to build a scale position, add a retail position, acquire trading skills, or diversify risk. An M&A strategy may be useful to an IPP Layer Player to get its foot in the door of a market. AES, for example, had that in mind when it acquired Argentine, Brazilian, and Central American wires companies, which set the stage for building power plants. Eastern Europe could afford similar opportunities. But while this approach may be attractive where PPAs are available, a pure generation player is unlikely to prove viable in most Western European markets.

Some of the IPP Layer Players aspire to become vertically integrated Regional Giants

Visit these sites for more information

24seven, Havering, England	www.24sevennet.co.uk
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Eastern Energy (now part of TXU Europe), Ipswich, England	www.txuenergi.co.uk
Electricité de France, Paris	www.edf.com
ENBW, Karlsruhe, Germany	www.enbw.com
Endesa, Madrid, Spain	www.endesa.es
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Enron, Houston	www.enron.com
Espoon Sähkö, Espoo, Finland	www.espoonsahko.fi
Fortum, Espoo, Finland	www.fortum.com
GdF, Paris	www.gazdefrance.com
HEW, Hamburg, Germany	www.hew.de
HidroCantábrico, Oviedo, Spain	www.h-c.es
Iberdrola, Madrid, Spain	www.iberdrola.com
Innogy, Swindon, England	www.innogy.com
International Power, London	www.ipplc.com
London Electricity, London	www.london-electricity.co.uk
Louis Dreyfus, Wilton, Conn.	www.louisdreyfus.com
Mirant, Atlanta	www.mirant.com
Montedison, Milan, Italy	www.montedisongroup.com
NRG Energy, Minneapolis	www.nrgenergy.com
Powergen, Coventry, England	www.powergen.co.uk
Reliant Energy, Houston	www.reliant.com
RWE, Essen, Germany	www.rwe.com
Sydkraft, Malmo, Sweden	www.sydkraft.se
Thames Water, Reading, England	www.thameswater.co.uk
TXU, Dallas	www.txu.com
Vattenfall, Stockholm, Sweden	www.vattenfall.com

What else is needed?

Earlier it was stated that an M&A strategy needs to meet three conditions: the business model makes strategic sense, has a firm financial basis, and includes other options if things don't work out as planned or the business climate changes.

This article has explored the first condition in some detail. Acquisitions need to strengthen an existing business model or build toward a new one. To do that right, the management team will need a deep understanding of its current competitive environment and the potential scenarios for the industry's future. Managers will also need a rich understanding of the three potential business models outlined above and the creativity to adapt and apply them in the complex and evolving European landscape.

A second condition for success is that M&A deals have a firm financial basis, meaning that the premium paid must be recoverable in synergies or performance improvements. Such benefits are often available, particularly if the merging companies are located close together. Typical synergies can boost profits of the combined entities from 5 to 20%. But the devil is in the details. Benefits must not only be identified up front, they also have to be aggressively pursued following acquisition. Post-merger integration is the messy process that every acquirer needs to face sooner or later if any extra value is to be extracted.

A third condition is that the deal includes other options for growth. In many cases, the limited availability of deals forces the acquirer to consider the option value of a deal to justify a price. Conversely, a company can target acquisitions that offer options of particular value—be it entry into a new market or a new skill, such as trading—that it can use in the rest of the organization. The implication for European players is that they should consider not only what business model to use, but the options that they value most highly as well. M&A deals can then be screened on this basis. For example, a Regional Giant might want to acquire options to build a complementary position in adjacent markets, or to become a dominant Layer Player in its own market were regulators to force it to break up (as happened to British Gas when it was forced to create Centrica).

Conclusions

For any merger or acquisition, the proof of the pudding is in the long-term performance of the combined entity. While the future is uncertain and especially subject to environmental changes, the likelihood of success can be greatly increased by using the three suggested criteria—strategic sense, a firm financial basis, and option creation. There will be many challenges along the way. Business models need tweaking to suit specific local market conditions and opportunities. Sometimes only minority shares in a targeted acquisition are available. Several acquisitions may be required, because it is the rare case in which a single acquisition allows a company to pursue a different business model. Some might even argue that being opportunistic is the only feasible strategy.

But without a vision of the longer-term goal, acquisitions run the risk of becoming—at best—bargaining chips for future dealmaking or—at worst—very expensive mistakes. ■

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