Big manoeuvres in energy: the winner loses

by
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Is a realignment of the European energy landscape underway? If not, how do we interpret the three-way moves between Enel, Suez and GdF, and between Endesa, E.On and Gas Natural with, in both cases, national governments who are clearly intervening and Brussels which will not fail to do so? What are the triggers? What can we expect?

The main objective is to increase the value of the business

At the time when EDF itself is listed on the stock exchange (bearing in mind that EDF was traditionally the European paradigm for the nationalised energy company and closely linked to public service), the structural challenge for the Board of an energy company is the creation of value which must be reflected by the rise in market price. The other aspects of management are of secondary importance: quality and security of the service, relations with the authorities, social management, productivity etc.

However, the value of a business is dependent on its profitability and its growth.

Profitability is a function of prices

For a long time, the energy companies have been optimising their production costs, rigorously managing their investments and developing their purchasing and logistical skills regarding fossil fuels among other things. In exactly the same way, the gas companies have forever been trying to minimise their cost per molecule, for the Europeans mainly through negotiation with the Norwegian, Russian, North African and other producers.

Efforts purely on productivity have, on the one hand, a weak impact (purchases and depreciation in production/sourcing representing a proportion that varies between 65% and 85% of the overall costs) and, on the other hand, have already largely been implemented.

The effects of scale in production are reduced, limited to the return on experience from nuclear and lignite power stations (for gas and, to a lesser extent, coal power stations, it is the generator who benefits from the effects of scale and experience).

The networks (electricity and gas) are or, depending on the situation and the country, are required to be strictly regulated and therefore are allowed only brief periods of profitability above what is regarded as appropriate by the regulator.

As regards marketing, it represents only a small proportion of the costs (typically between 5 and 10% of the total for the major energy companies).

The potential for improving the margin through cost reduction is therefore low.

Changes in profitability are therefore determined mainly by those in prices, bulk and final: 2005 was an extraordinary year for all of the energy companies, because the bulk prices and, in their wake, the majority of the final prices[1] grew sharply more than the costs.

In the light of this, the energy companies are profiting from the windfall effects linked to the price and are turning towards growth to increase their value, even though this growth does not permit them to benefit from significant scale effects.

Growth is weak

The trouble is that the energy market in Europe is typically growing at only 1 to 2% a year.

This growth results from the change in GDP, the partial de-industrialisation of Europe, which is moving towards services and consumes less, and from the emergence of new demands, particularly for air-conditioning in the southern half of the continent.

Growth through diversification into services remains a perennial issue : the synergies between the sale of energy and the sale of services linked to energy are tenuous or non-existent and the expertise and teams inevitably unconnected. The major players failed in their attempts to develop significantly in this direction.

The acquisition of energy companies outside Europe, in the emerging countries, can turn out to be risky: the authorities there are making sure that tariffs remain low, corruption is rife and the investment needs are high. Many countries are closed to investors in this sector, which is regarded as strategic. The few pockets that are available and attractive (for example, Chile) are small (on the scale of a major European energy company) and are already 'taken' by one energy company or another. The current potential for growth is very weak.

The same goes for the countries in Eastern Europe, where the major western energy companies (German, French, Swedish etc.) have already acquired the majority of the available targets.

In the United States, consolidation is being carried out by the national players, and the rise in protectionism does not provide a favourable omen for a possible foreign takeover of the country's energy.

In Germany and in Italy, the state-owned companies that, five years ago, appeared to offer significant potential for consolidation are today out of reach, either because they have come under the control of the major groups or because they have consolidated between themselves to become major players. Moreover, the national competition authorities are nowadays very keen to avoid increased consolidation and are tending to block such plans.

The major energy companies must therefore diversify or buy up sizeable competitors.

Diversification does not have a good reputation. In an almost universal manner, diversified holdings suffer a below-par rating of their stock exchange value, investors preferring, for simplicity, to build up their business portfolio themselves rather than buying 'ready-made' portfolios.

This is evidenced in the withdrawal by RWE and E.On from their non-energy activities over about the last five years and their recent purchases of holdings in gas and electricity. Where activities in telecoms, water, real estate and, previously, chemicals and logistics were being undertaken, they have been or are being disposed of by these groups. Similarly, Centrica has disposed of its activities in roadside recovery services and telecoms.

[1] Except for diffuse customers (individuals and SMI-SME) for whom the prices vary in a more smooth manner and except for the countries where a tariff still governs certain groups of customers (Spain, France, Italy etc.)

A single solution

One must therefore take over a 'member of the club'.

The synergies released at the time of such mergers thus come to the forefront. But, in reality, due to the lack of opportunity for economies of scale, the synergies are, above all, between gas and electricity and are limited to two aspects:

- The purchase of gas (for sale to the final consumer and use, where relevant, as a fuel for electricity generation). Faced with very large producers and in markets with very volatile prices, the advantage of this is weak;
- Commercial. These synergies only materialise in cases of geographical overlap, by merging two brands in such a way as to reduce the costs of marketing and sales. An acquisition leading to this situation is rare.

The other possible gain is an improved negotiating position with respect to the coal producers, who are themselves global players in very volatile price markets. The expected benefits remain weak.

Despite the lack of economic interest in such operations, acquisition prices are rising well above the current value of the targets.

Ill-advised use of resources

The expected consolidation can therefore turn out to be a fool's bargain for the shareholders of the buyers, the excessive prices paid or potentially paid being forgotten in the euphoria of the results for 2005 (and 2006). Movements on the European energy scene may be more Brownian than economic.

Perhaps it would be better to give the money to the shareholders rather than investing it in the purchase of overpriced businesses without much potential for synergies.

April 2006

Estin & Co is an international consultancy in strategy based in Paris, London, Geneva and Shanghai. The firm assists the boards of major European and North American Groups in their growth strategies, as well as private equity funds in the analysis and value improvement of their investments.