

# The ‘utilities’, or how created value is taken out over the long term

by

Christophe Moret

Vice President, Estin & Co

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The sudden rise in all of the energy prices (petroleum, gas, electricity), even though it is under the influence of different market situations depending on the case (demand from China and India, assertion of Russian interests, reinvestment needs of the electricity companies in Europe), makes any purchase of a business in the sector extremely expensive.

On the one hand, because there are few targets (due to the growing consolidation of the players) and, on the other hand, because the rise in energy prices is making the energy companies (buyers) wealthy and prepared to invest at higher price levels.

The recent overbids for Endesa by E.On, the prices contemplated in 2005 for the purchase of Scottish Power, also by E.On, and the rise in the market price of EDF since its entry onto the stock exchange all demonstrate that the investors see electricity and gas companies as the land of El Dorado.

The ‘utilities’<sup>1</sup> are benefiting from this aspiration. The few German Stadtwerke<sup>2</sup> still to be bought up (in all or part) are at breathtaking prices.

Is this enthusiasm justified in the long term?

## **Lack of growth ...**

An attractive investment, in a simplified way, offers significant growth opportunities (in turnover and/or profits) which should generate a substantial increase in future cash flows.

But the demand for electricity in Europe is not likely to exceed 3% per year in the coming years and will probably be lower under the combined effects of DSM<sup>3</sup>, encouraged and subsidised by the European governments, and of a partial de-industrialisation of Europe. Domestic gas consumption will rise by about 2 to 5% per year, as long as prices do not increase too much, in which case the elasticity of demand will reduce this growth. As for water consumption for domestic use, this should not change significantly.

So, an underlying lack of growth.

Growth through acquisitions remains possible but it is expensive and as a result offers only small potential for improvement in profitability. There is little synergy in putting two unconnected distribution networks under the same management (from one town or city to the next) or two integrated, interconnected electricity companies for a small proportion (typically less than 5%) of their average power utilisation. Acquisitions create only a small value above their current, very high purchase price.

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<sup>1</sup> Companies such as Suez or Veolia: generation, distribution and sale of electricity, transport, distribution and sale of gas, district heating systems, but also water administration, household waste management and energy services

<sup>2</sup> Managers for the distribution and sale of electricity and gas in their towns, but also for the management of water, household waste, even public transport, swimming baths and car parks

<sup>3</sup> Maîtrise de la Demande d’Electricité (or d’Energie), Demand Supply Management in English

### **... but prospects for profitability**

Improvement in profitability is possible, on the other hand, in particular when energy prices are shooting up, the players typically tending to increase their final prices more than their costs are rising.

Even without such a windfall effect, a policy of split prices (if it is not curbed by the imposition of tariffs) enables a marked improvement in results. At the end of a time of monopoly (national in France, regional in Spain or local in Germany) and depending on the competitiveness of the environment, prices can vary from one segment to another by almost two-fold, with an average often being above that of the historical tariff (to a lesser extent in countries where the latter was very high, such as Germany). Such an approach takes into account the sensitivities of the customers to the prices and to various aspects of the offer, the costs linked to a customer (energy, transport, marketing) and the competitiveness of rivals in a given customer segment (a new entrant would clearly have higher costs to approach a large body of customers, but comparable costs to serve a major industrial customer).

A wiser management of investments (in generation and transport) also allows an appreciable improvement in profitability. In particular, this involves avoiding setting too high a standard. Within the networks especially, in the final decades of the last century there was a tendency, through a lack of knowledge of the relationship between the levels of investments and reliability, to invest excessively (cross-linking of the network, doubling or tripling of substations and the equipment within the latter etc.). Nowadays, through the use of statistics and benchmarks, it is possible to correlate the required level of quality (often imposed by the regulator) with the necessary infrastructures. Thus, in Germany today they no longer replace, or even maintain, some installations or sections of the electricity grid without this having any adverse effect on the quality level in either the short or the long term.

Lastly, an improvement in profitability is also possible through increased productivity, particularly in activities such as the networks, where extensive preventative maintenance policies were the norm (systematic replacement of elements of the infrastructure) without being able to justify them on an objective basis. These days, the graphs are better understood, as are the possible impacts if this or that item of equipment or network configuration goes down, which makes it possible to determine precisely if and when an equipment renewal is worthwhile. Significant savings are therefore possible.

### **The obligation to share the profits**

The problem is that, in fact, the 'utilities' are not operating in an environment free of all political influence. They are close to the authorities: they are operating within the framework of a Delegation of Public Service (water, waste etc.), they are a very significant local employer, managing a substantial part of the urban infrastructure, etc.

Partly through their final prices, the major integrated electricity and gas companies define the industrial attraction of their region or country.

Regulation, more restrictive as the energy markets are becoming more liberalised, also imposes heavy constraints, particularly and increasingly on the supply networks and their access tariffs, revised (downwards) every three or five years, depending on the country.

This situation places the 'utilities' in an unfavourable position as much on prices as on costs.

### **Price ceilings and controls**

Prices are monitored. Without necessarily arriving at a situation as marked as that of France (where, in the case of electricity, it is proposed that even customers who have opted for open prices could 'cling onto' the tariffs), the authorities in all countries are monitoring prices, which are considered, wrongly or rightly, as politically sensitive.

It is therefore out of the question to put up prices without consultation with the relevant authorities (local, regional or national). In France, the Minister agrees or rejects the tariff rises proposed by EDF and GdF. In Spain, the situation is similar to that of France, with the tariffs

(low) defined by the State and the majority of customers (including certain major ones) still benefiting from these tariffs. In Autumn 2004, the German Chancellor Schröder summoned the heads of E.On and RWE, even though wholesale prices despite being high were still heading upwards, to warn them of the government's concern and its intention to intervene if prices were to continue to rise. As a result, there was a noticeable pause in the rise in prices ... Only the UK was an exception, the freedom of final prices there being almost total.

This situation is even more marked in the newer member States of the European Union: prices for district heating in the CEEC and the Baltic states are fixed by the authorities, often without indexation to the price of the fuel used, which created serious problems for the operators at the time of the last rise in gas prices ...

Water, in France as in England and elsewhere, has also become a politically sensitive product the price of which is subject to close monitoring ...

An aggressive pricing policy is not politically acceptable.

And it is out of the question to put jobs at risk by increasing prices to the major electricity-intensive industries (aluminium, chloro-chemical, paper etc.). In every country, there are agreements, open and transparent to a greater or lesser extent, that are intended to encourage the setting up or maintaining of these industries at the national level. These customers must be served, even at a zero or negative net margin.

The creation of value through an informed pricing policy is ... difficult.

### **Gains from productivity**

And efforts to improve productivity? In the regulated activities (supply), these are taken into account in the next tariffs and go to the shareholder only temporarily. This means keeping ahead of the regulator and getting one's costs down more quickly than he can lower the tariff. This is an arduous task and it becomes even more so as productivity is improved.

In the at least partially deregulated activities, we rediscover the problem of pricing: if costs fall significantly and the margin rises accordingly, the authorities will want at minimum either for the benefits to be shared with the customers or for them to offset the rise in primary energy.

In any event, the customer will clearly benefit more than the 'utility' from the efforts of the latter.

### **Other energy companies don't have this problem**

An oil producer (or an upstream gas producer) is not faced with this problem: even though its product is vital for a country it is not, in any country in Europe, solely or even mainly responsible for the supply of final products. Its own products are easily stored and transported, markets are sound and fluid ...

This freedom is reflected in the value: over the last 10 years, a shareholder in Total who had automatically reinvested his dividends in the business gained 19% per year on his outlay<sup>4</sup>, 16% for British Gas, 13% for Exxon and 12% for BP (not to mention 26% for Petrobras).

In contrast, the pure electricity companies hardly seem attractive: 6% for Duke (one of the three major American electricity companies with Edison (10%)) or, worse, 3% for Enel.

The 'utilities' come in the middle: 10% for Suez, 12% for Endesa and RWE, i.e. the Stock Market average over this period.

Without constraints, the 'utilities' would undoubtedly have had financial yields 20 to 50% higher. Sometimes it appears better to be a customer than a shareholder ...

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<sup>4</sup> TSR (Total shareholder return), i.e. gains in capital, dividends, obtaining of shares free or at a reduced price etc

*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.*