Restructuring for Value in an evolving energy market

There are a number of recent developments that are likely to have a major impact on energy market dynamics. Thomas Yeung, Craig Rice & Jon Hubbard of PricewaterhouseCoopers examine three very different business models that have evolved in Australia and New Zealand.

The Context

As in other parts of the world, electricity and gas markets in Australia and New Zealand are changing rapidly and energy companies have had to develop effective strategies quickly in order to survive. The major changes to note are:

- **Continuing convergence between gas and electricity retailing:**
  Two of the Victorian gas retail/distribution businesses have been bought by existing Victorian electricity businesses (Eastern Energy (a TXU company) and United Energy (owned by Utilicorp), and the third was bought by Boral/Envestra, which is a major gas player in New South Wales.
- **Recognition of the significant differences between the regulated networks businesses and the highly competitive supply businesses:**
  Boral separated out its regulated network businesses into Envestra, a separate company with a different ownership structure and appetite for risk: Envestra was then partially floated and now operates as a specialist regulated networks business. GPU (in line with its global strategy of becoming a specialist network asset manager) sold the electricity business Citipower to AGL (the largest gas company in Australia) when it bought PowerNet Victoria, the state transmission company.
- **Potential political pressure for disposal of either the regulated or unregulated business:**
  In New Zealand, recent legislation forces companies to choose between regulated and unregulated businesses - they are not allowed to retain both activities. However, there are no restrictions on vertical integration, e.g. fuel supply, generation, and electricity supply.

Even though the three organisations examined in this article operate in very different markets and circumstances, the major challenges faced by the leaders of these three organisations have some common themes:

- What combination of assets/skills/capabilities do we need in order to succeed? Do we have them, and if not, how do we acquire them? Once acquired, how do we make sure we realise all the value anticipated?
- How do we work effectively within the regulatory environment? What constitutes market power? Can we defend our position effectively if required to do so?
- Can we leverage internal and external capabilities and resources - alliances, joint ventures, ‘partnership’ arrangements?

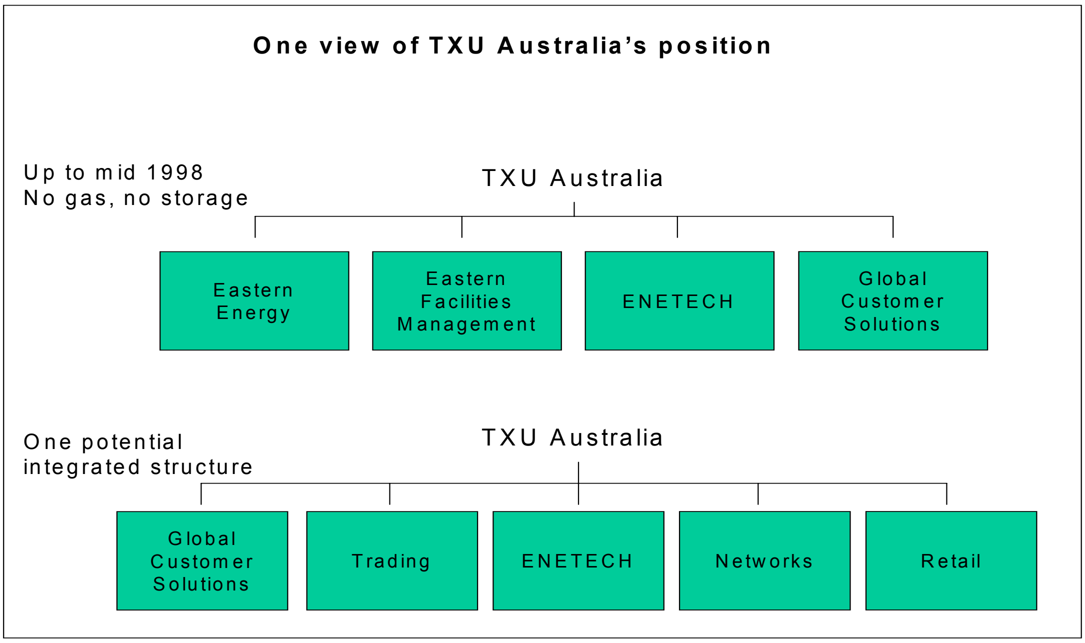
- How do we compare with our competitors (current and potential) in each of the activities that we do? Are there any that we can outsource to others? What about opportunities for selling our skills to others?

The Companies

TXU Australia

TXU Australia consists of a number of energy-related businesses: Eastern Energy (the electricity retail and trading business), Eastern Facilities Management (the network management business), Enetech (infrastructure construction and management), and Global Customer Solutions (customer service). All of these businesses are encouraged to be entrepreneurial and competitive: Global Customer Solutions and Enetech already have several dozen third-party clients, though Eastern Energy remains their major customer.

Eastern Energy was one of five retail/distribution companies created as part of the reform of the Victorian electricity industry. During 1993 and 1994, the Government considered a number of different approaches to reforming the industry, and finally decided upon full-scale privatisation (partly for ideological reasons, and partly because the Treasury needed to reduce State debt). The retail/distribution companies were the first to be privatised (in 1995 and 1996), and Eastern Energy was bought by Texas Utilities in November 1995 for AUD2.08bn. It is one of the larger electricity companies (by geography and customer numbers), and its core electricity distribution business serves approximately 500,000 customers in the Eastern part of Victoria.



TXU Australia has been active in building its portfolio of businesses. In June 1997 the company bought Streamline Australia from Melbourne Water, rolling it into Enetech, and in December 1997 it bought VPX Metering (the incumbent metering agency for Victoria), incorporating it into Global Customer Solutions. In November 1998, TXU Australia paid AUD25m for the right to build, own, and operate Victoria's only underground gas storage facility, thus signalling its strong intention to buy one of the three gas businesses being privatised by the Victorian Government. No one was surprised, therefore, when in February 1999 TXU Australia was successful in its bid for Westar/Kinetik, the first of the stapled gas retail/distribution businesses to be sold, at a price of AUD1.62bn

The Westar/Kinetik acquisition makes TXU Australia a true multi-utility business, and enables the company to compete actively in a number of areas within the supply chain without regard for physical energy flows. More generally, it can be argued that participation at multiple levels in the Supply Chain enables TXU Australia to identify attractive opportunities. In terms of the electricity market, TXU Australia has already expressed its interest in acquiring appropriate generation assets when they become available, which may include plant in Queensland, NSW, or South Australia or 'virtual generation' such as commercial control of an interconnector or large-scale demand management.

Texas Utilities is no stranger to multi-fuel portfolio management: through its 1998 acquisition of Eastern Group in the UK, they have acquired wide ranging energy trading skills, and several international observers have drawn parallels between TXU Australia's emerging multi-fuel strategy, and that multi-fuel, vertically integrated strategy adopted by Eastern Group.

Like Eastern Energy, Eastern Group started as a relatively large electricity retail/distribution company, which quickly moved into gas and energy services. But Eastern Group has had the opportunity to take vertical integration further, in that they also control generation assets, manage large fuel contracts, and are able, in principle, to arbitrage between gas and electricity markets through their wholly-owned gas fired generation such as Barking and Peterborough, as well as through the electricity and gas portfolios.

TXU Australia has declared its intention 'to be the leading provider of energy and related services in Australia'[1]. They seem to recognise the importance of building critical mass in each market, and the potential benefits of integration up and down the value chain, and across gas and electricity markets, and clearly see strategic acquisitions as an effective way of achieving this.

Energex Queensland

The Queensland electricity industry has undergone significant change in recent years, even though it has remained largely in State ownership. In January 1995, the Queensland Government corporatised the vertically integrated Queensland Electricity Commission, and separated the generation assets (which became Austa Electric) from transmission and distribution. In December 1996, the industry was further reformed to introduce competition in generation and supply. Austa was split into three competing generation entities (plus a generation services company), with these new entities competing in an interim state electricity market until the start of the National Electricity Market. The transmission and distribution companies became government owned enterprises in their own right, and three new retail businesses were created:

[1] See their web site: easternenergy.com.au

Northern, Central and Southern Electricity Retail Corporations. These were owned by the distribution businesses, and were initially vested with the customers associated with each wires business. Southern Electricity Retail Corporation (part of the South East Queensland Electricity Corporation, now trading as Energex) was by far the largest retailer, and ultimately the Northern and Central Electricity Retail Corporations merged to form Ergon, which remained in the ownership of the six smaller distribution businesses. A decision has now been taken to merge these six 'wires' businesses into one.

Energex is the trading name of both the South East Queensland Electricity Corporation (the largest distribution corporation in Queensland, and the second largest in Australia), and its wholly owned retail business. For clarity, in this article we will refer to the distribution business and holding company as Energex, and the electricity and gas retailing business as Energex Retail.

Energex provides power to approximately 1million customers in Brisbane and south east Queensland, and owns and operates a AUD2bn electricity distribution network. Energex bought Queensland-based gas distributor Allgas Energy Ltd ('Allgas') in 1998, beating off competing bids from Texas Utilities and Boral/Envestra. Energex offered AUD23.00 a share, a premium of some 84% over the AUD12.50 share price before bidding started in February 1998, and 13% more than the nearest rival.

Brian Blinco, CEO of Energex seemed confident: in a statement at the time, he confirmed that Energex would offer A$23 per share for Allgas Energy Ltd, effectively valuing the Brisbane-based gas distributor at about A$250 million, adding that the move was

> *'. . in line with Energex's strategy to become a multi-utility, strengthening its position in the deregulated and increasingly competitive energy market'*[2]

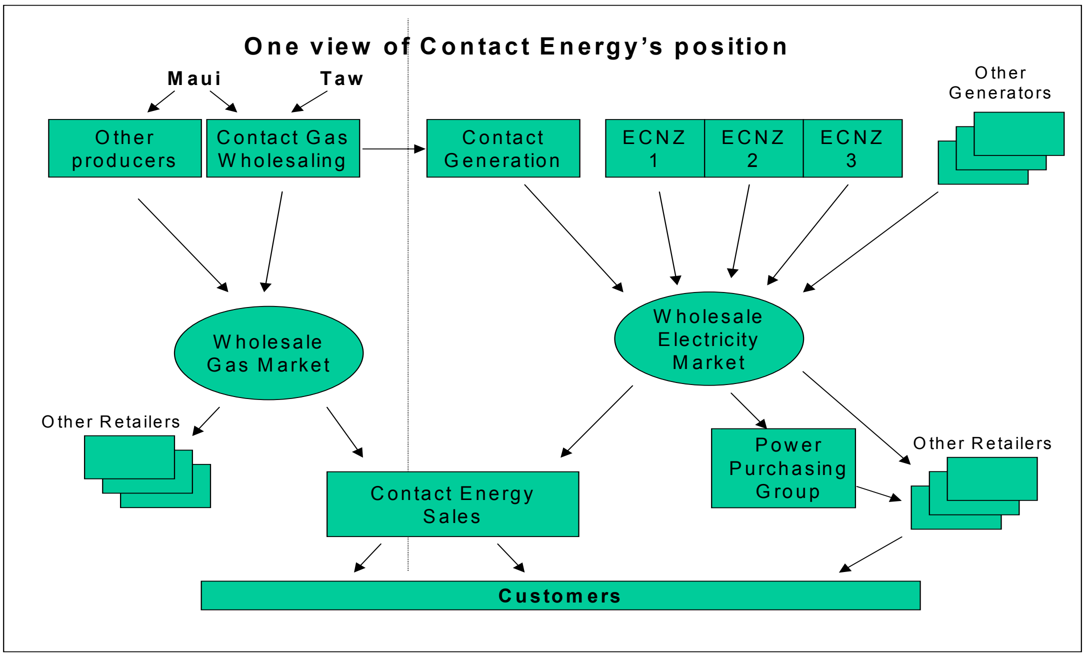
Several analysts suggested at the time that this acquisition may have been defensive as well as strategic: if other energy retailers acquired a credible presence in South East Queensland, Energex Retail's own customer base might have been threatened.

In parallel with its move into gas, in 1998 Energex joined Citipower and Energy Australia (collectively the 'Downtown Utilities') in a joint venture with US-based Williams International and Australian carrier Spectrum Network Systems Ltd. which will introduce further competition in the Australian telecommunications market. The consortium intends to use existing underground electrical ducts to roll out an advanced broadband telecommunications network in the main business centres of Sydney, Melbourne and Brisbane. It also plans to use synergies between telecommunications and energy provision to offer a range of integrated services.

[2] Energex media release: 24 June 1998

Contact Energy Limited

Contact Energy ('Contact') was created in November 1995 when the New Zealand Government split the existing monopoly generation company into two competing entities (ECNZ and Contact). It was vested with eight existing generation units, two hydro stations in the South Island, two geothermal units in the centre of the North Island, and four gas plants in the North Island, with a capacity of about 2.0GW in total. The company produces around 26% of New Zealand's electricity. Subsequently Contact has commissioned a new 390MW CCGT (Otahuhu B), and a small cogen project (45MW) at Te Rapa and has bought a 27.7% stake in Southern Hydro in Victoria, and a 17% stake in a new gas fired plant under construction at Oakey in Queensland.



Outside the core generation business, Contact owns the rights to 43% of the Maui gas field (which supplies around 80% of NZ total gas requirements), and the whole of the TAW fields (a much smaller contract at between 9-12PJ pa). Some of this gas is used in its own thermal power stations and the remainder is sold to wholesale (including other licensed gas suppliers and competing generators) and retail gas customers. In December 1998, Contact gained NZ Commerce Commission approval for its acquisition of the gas retailing business of Enerco New Zealand Ltd (the largest natural gas retailer in NZ with approx. 105,000 customers), making Contact the most significant wholesaler and retailer of natural gas in NZ.

Contact has actively acquired electricity retail businesses, taking advantage of the opportunities created by the passing of the Electricity Industry Reform Act on 8 July 1998. The objective of this legislation was to increase competition in electricity generation and retailing by splitting ECNZ into three smaller units (each still an State Owned Entity) and forcing all energy companies to choose between their distribution ('networks') and retail ('supply') businesses. Most of the smaller companies chose to retain their networks business and to divest their supply business, and some chose to exit the market completely. Contact has bought eight electricity retail businesses to date, and currently supplies around 346,000 customers with electricity. These customers consumed around 12% of New Zealand's total electricity generated in 1998. Contact believes that entering the electricity retail market will further diversify its revenues and provide a relatively stable customer base, and will also form a natural hedge for wholesale electricity traded on the spot market, over the next several years.

Contact's key business strategy is to become New Zealand's leading electricity and gas supply company. As part of this strategy Contact aims to increase its retail market share through organic growth and cross-selling of electricity to its retail gas customers and vice versa, as well as expanding gas sales to large industrial users. Contact also hopes to make further acquisitions in the event that the energy retail market further consolidates.

In addition, Contact intends to diversify its revenues to a greater extent through targeted growth in new generation projects and by targeting potential international business expansion into countries where it can utilise its skills and experience.

Some Observations

The experiences of three companies discussed above raise some interesting issues:

What assets/capabilities are required for success? Do you need a multi-fuel offering?
All three companies have elected to expand their operations: TXU Australia and Energex have entered the gas market by acquiring major players in their local market, and are busily integrating the gas businesses in order to achieve the promised economies of scale/scope. Contact was vested with an upstream gas business, and it has supplemented this by buying Enerco to gain access to retail customers. So all three companies retail both electricity and gas, but to date only Contact owns the physical assets to convert gas to electricity. Of course, as gas fired generation plant becomes available (say, in South Australia or Queensland), both TXU Australia and Energex can, in principle, try to buy these assets, but they could also choose instead to develop some kind of strategic relationship with a generator whereby both parties share the risks and benefits of being able to switch between the gas and electricity markets.

What about participation up and down the value chain ? Does this add value?
Contact started life with some upstream involvement (in that its generation plant cannot be held to ransom by fuel suppliers) and has since moved downstream into gas and electricity retail. At present, both Energex and TXU Australia have to negotiate with generators in order to buy electricity to sell. On the gas side, TXU Australia has the flexibility afforded by access to underground gas storage, which gives it (and indeed, other gas retailers that contract with that facility) virtual production at times of peak demand in winter, as well as the capacity to offer improved load profiles when negotiating with the gas producer(s). TXU Australia has stated that it is willing to make more storage capacity available to third parties if there is sufficient demand, and so they appear to have foregone the possibility of withdrawing capacity to raise gas prices at peak periods. Energex has declared its interest in buying generation plant in Queensland or elsewhere, and so clearly all three companies perceive benefits in moving up and down the value chain.

Interestingly, in Victoria, most coal fired generation plant is vertically integrated: the majority of the generation assets that were sold included the plant and the associated coal field. This may be a result of the historically close relationship between coal and the generation plant: Victorian brown coal is of such a poor quantity that each furnace has to be specially built to match the combustion characteristics of the fuel, and so there is no chance of selling coal from one site to be burnt at a completely different generator. The coal mine and its generator have a true symbiotic relationship.

We have also observed that some of the fuel suppliers in NSW and Queensland are taking an active interest in the operation of the electricity pool, and we expect that tolling arrangements driven by fuel suppliers (as seen in some markets in Europe) may well develop.

Is there an ideal organisational structure?

So far, TXU Australia is the only company to comprehensively separate out its customer service and other businesses. Both Energex and Contact have had some success in selling the skills of their employees to third parties (generally other distribution businesses), but without clear separation of businesses it can be difficult to be certain which add value, and which, if any, destroy it. For example, an energy company might always have offered contracting services (rewiring shops and offices, maintaining street lights and traffic signals, etc.) , and might believe that it was making money on these activities, but unless all the overheads and other costs(including the cost of debt and equity) were accurately recorded, it might really be destroying shareholder value. Activity based costing and other accounting techniques help, but we have observed that full separation of the businesses may provide greater clarity and sometimes develops unexpected levels of entrepreneurship in the General Managers. In some cases, we have also observed improved motivation and enhanced camaraderie within the business, as the staff feel more responsible for their own future.

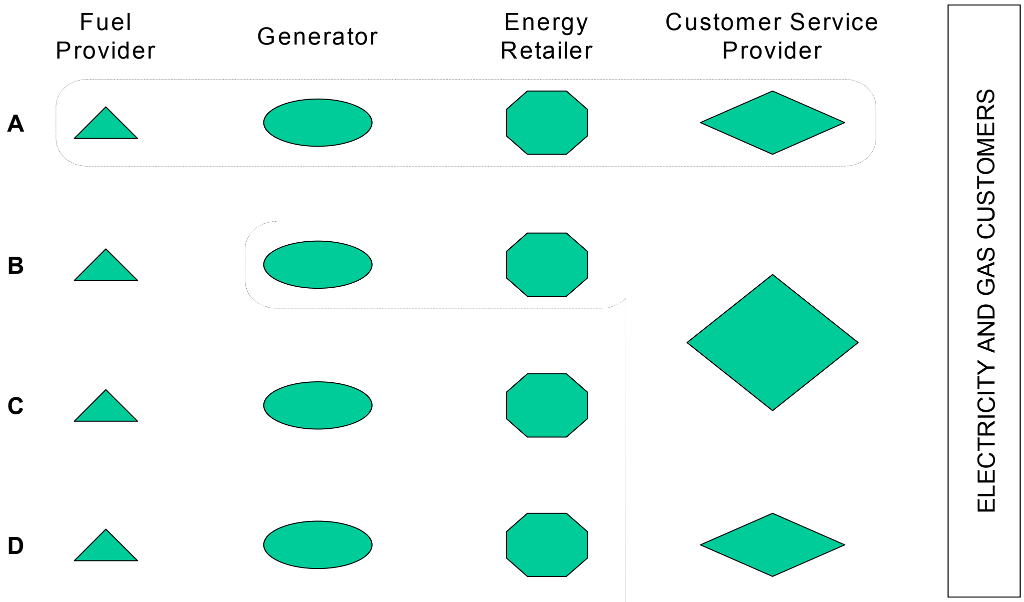
What is the relationship, if any, between supply and distribution?

In New Zealand, recently-introduced legislation forbids simultaneous ownership of supply and distribution licences. In Queensland, the two incumbent retail corporations are owned by the distribution businesses.

Energex Retail is a subsidiary of Energex, but Ergon Energy is owned jointly by the other six distribution corporations (although they are presently being merged into one). In Victoria, the Government has recently sold three 'stapled' gas entities with separate supply and distribution licenses (as required by the National Access Code, but perhaps on the expectation that some or all of the potential buyers would want to split the assets): and supply and distribution licenses are separate in electricity as well. Clearly, Antipodean regulators believe that there is no reason why the competitive supply business and the regulated distribution business should stay together, and we consider that European regulators are likely to want ever clearer separation of the competitive supply business from the regulated distribution business, but they may not require companies to divest one or other activity as in New Zealand.

Likely Implications

Based upon observations in the New Zealand and Australian electricity and gas markets, it seems that there are a number of different ways in which energy and utility clients can achieve sustainable success.



Our expectation is that inertia, switching barriers, and customer price inelasticity may, to some extent, protect incumbent suppliers for a few years, but that in the long term energy companies should think long and hard about their corporate capabilities and strengths, and then focus on being the best in one or two strategically-chosen parts of the value chain, leaving the rest to others who are specialists in those areas.

One corollary is that companies going for rapid growth in market share may need to focus on buying out an inefficient incumbent service provider with an existing customer base rather than try to grow organically. Another is that those companies that cannot achieve competitive advantage in any area or combination of areas should exit as soon as possible, because doing otherwise destroys value.

In this article, we cannot hope to offer recommendations on which strategy is best for YOUR business - there are no absolute answers, and the most appropriate approach will depend upon your own specific capabilities, aspirations, position, and stakeholder demands. We would be happy to work with you to develop your strategies, and our people can draw upon the experience of many different markets, not just those of the Antipodes.

About the Authors

The three authors are part of the PricewaterhouseCoopers Global Energy & Mining practice. Thomas Yeung worked in the UK electricity industry for ten years before joining PricewaterhouseCoopers in Australia, and has advised major energy companies in the UK, Australia and New Zealand on strategic issues for three years. He is now based in London. Craig Rice is a Partner in our Financial Advisory Services group in Auckland, and leads the utilities practice in New Zealand. He has been lead adviser on many of the recent electricity business acquisitions, disposals and mergers in New Zealand, and has advised on deals with an underlying value in excess of NZD3bn. Jon Hubbard leads the Financial Advisory Services utilities focus in Australia, and has advised both governments and private sector clients on numerous reform, regulatory and strategic matters, as well as a large number of utility sector mergers and acquisitions.