



TRANSACTION SERVICES

Powering ahead

Mergers and acquisitions in the global power and utilities industry

ADVISORY

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NOTE

The underlying survey and interviews were conducted by the Economist Intelligence Unit. The confidentiality of individual responses was guaranteed as a condition of participation.

KPMG would like to thank all respondents for their participation.

Introduction

This Power and Utilities survey has input from 40 senior executives drawn from some of the largest global power and utilities companies, by turnover. The survey helps to provide valuable insight into current and future industry trends

The power industry is seeing a spate of major deals, with some of the largest transactions the sector has seen being completed within the last 12 months. This consolidation, on both sides of the Atlantic, is driven by a number of factors: on-going deregulation; the search for secure energy supplies; and the availability of debt to support strong corporate balance sheets and potential financial buyers who are playing an increasing role in the sector. While the restructuring of the industry is in the early stages, it is expected to gather momentum as large, consolidated players begin to vie for markets that previously had been dominated by entrenched incumbents.

The International Energy Agency's *World Energy Outlook*, published in 2006, supports this increase in activity. It expects the level of required investment in the electricity sector between 2005 and 2030 to be US\$11.3 trillion, a significant increase on the previous estimate of US\$10.2 trillion.

For power and utilities, the merger wave offers both promises and risks. The opportunities include expanding to new geographic regions, introducing new products and services, diversifying fuel sources and reducing costs through economies of scale. The risks include dealing with protectionist regulators, possibly over-paying for assets in a super-heated market, and – if the merger goes through – the possibility that cost savings may prove elusive.

This study highlights the following themes as being of importance in the current environment:

- Growth rates in the sector are likely to accelerate with general economic expansion and increased demand for energy.
- To take advantage of this growth, and to respond to deregulation and increased competition, utilities in major industrialized markets are expected to expand their businesses by acquiring or merging with other utilities.
- Cross-border deals will become more frequent, and a number of mega-utilities are expected to emerge, especially in Europe.
- As mega-players build up significant presences in multiple markets, mid-sized and smaller players are likely to come under increasing competitive pressure.
- Poor grid interconnections can create obstacles for merging utilities in neighbouring or even distant states.
- Merging utilities often have difficulty achieving production economies of scale, since the 'product' – electricity – cannot be easily stored or transported.

Key survey findings

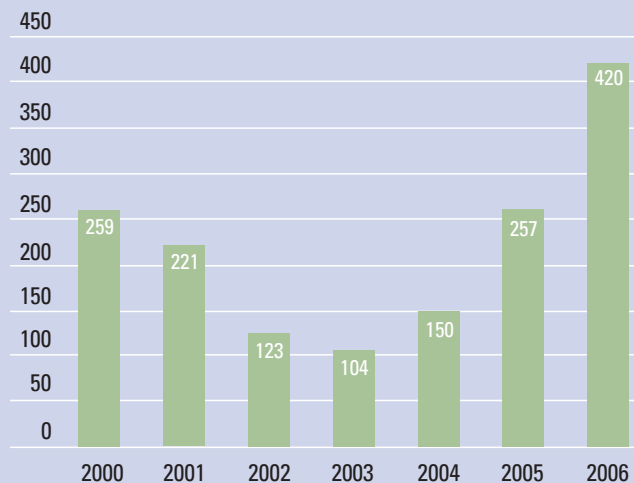
Cross-border consolidation is expected to continue apace, as deregulation takes hold in Europe and as utilities in the U.S. seek new efficiencies

Utilities set their sights on acquisitions

- Among respondents questioned for this survey, 87 percent expect further consolidation in their national market in the next three years. Similarly, 82 percent expect further consolidation internationally in the same period.
- Nearly half (47 percent) of respondents' companies had acquired another utility in the past three years. Three out of five said they were actively seeking acquisitions.
- Cross-border consolidation is expected to continue apace, as deregulation takes hold in Europe and as utilities in the U.S. seek new efficiencies.
- Within Europe, merger activity to date has focused on the most liberalized markets, such as the U.K. and the Netherlands, and on high-growth markets such as Spain. Deregulation in Central and Eastern European countries continues to build pace, presenting many future acquisition opportunities. Utilities in other EU countries are also expected to become acquisition targets under the pressures of market deregulation and concerns about security of supply.
- Respondents perceive China, India, Australia and Russia as offering the best prospects for future growth.

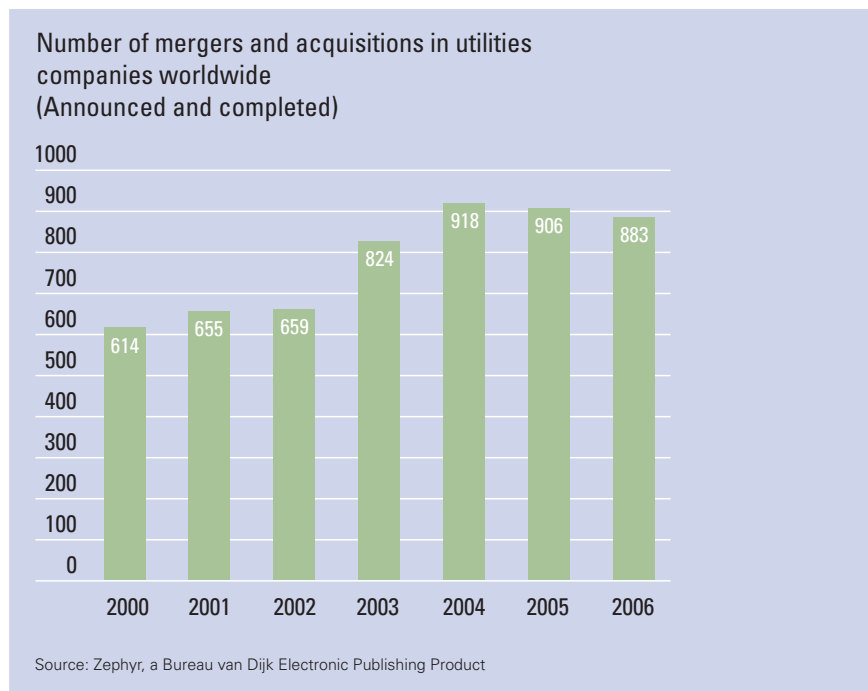
Global M&A activity: 2000-2006

Value of announced and completed global M&A transactions in the Utilities sector (US\$bn)



Source: Zephyr, a Bureau van Dijk Electronic Publishing Product

The value of deals increased from US\$257 billion in 2005 to US\$420 billion in 2006, despite a fall in the number of deals, reflecting the shift towards high value acquisition activity



A two-pronged strategy for growth

- In general, respondents have high expectations of future growth rates for their businesses, with 42 percent of respondents indicating that they expect growth in excess of 20 percent over the next three years.
- Despite intensifying appetite for acquisitions, incremental growth remains a cornerstone of business strategy for most utilities. Asked from where they thought the most important sources of growth would come, 65 percent of respondents note that they expect organic growth to be more important to their businesses than growth by acquisition.
- Competition from larger, consolidated players is a major driver of M&A activity. Half of respondents cite this as being a significant objective for acquisitions over the past three years, while 48 percent cite a drive for greater cost efficiencies.
- More than half (53 percent) of respondents say the main goal of M&A is to increase market share. Respondents also cite acquiring new products and services (37 percent), entering new geographic markets (32 percent) and improving economies of scale (32 percent).
- Looking ahead to acquisitions over the next three years, the objectives of penetrating new geographic markets and increasing economies of scale are seen as becoming more important, with the former goal cited by 46 percent of respondents, and the latter by 44 percent.

Barriers to consolidation

- Government intervention and a price expectation gap between buyer and seller are slowing the pace of consolidation, with 51 percent of respondents citing the former as a hindrance, and 45 percent the latter.
- In cases where acquisitions were planned but not completed, the factor most likely to have led to the failure is an excessively high price expectation by the seller, cited by 35 percent of respondents.
- One-third (33 percent) of respondents say mergers were not completed because too few synergies were expected, and another 30 percent say mergers were not completed because the target was deemed too risky.

Approach

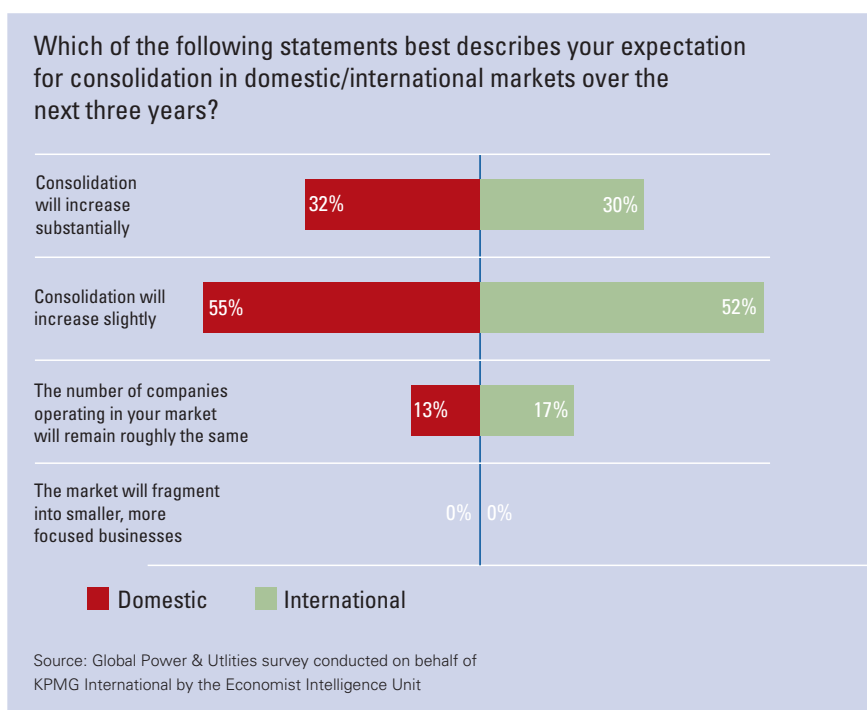
The study, undertaken by EIU, is based on a survey of 40 senior executives drawn from some of the largest global power and utilities companies, conducted in November and December 2006. Supplementary to the survey results, interviews were also conducted by EIU during January and February 2007, with the following senior executives at leading organizations in the sector:

- Duke Energy – Paul Barry, senior vice-president and chief development officer
- EDF Energy – Stephane Ramon, group financial controller in the U.K. and former head of M&A
- Edison Electric Institute – Jim Owen, director of communications
- E.ON – Dierk Paskert, senior vice-president corporate development
- Morgan Stanley – Emmanuel Turpin, utilities analyst
- National Grid – Humza Malik, director, group strategy and corporate development
- Standard & Poor's – Richard Cortright, managing director, utilities ratings, U.S.
- Wessex Water – Keith Harris, director of finance and policy

Acquisition appetite is growing

The power and utility sector in industrialized countries is gearing up for a major period of consolidation and restructuring. A strong majority (87 percent) of survey respondents expect consolidation in their domestic markets to accelerate over the next three years. Similarly, 82 percent expect that consolidation activity will accelerate internationally.

Expectations for consolidation



Views on consolidation activity are similar in both domestic and international markets

There are already clear signs of an increase in M&A activity. Nearly half of survey respondents (47 percent) said their companies had acquired another power business in the past three years, three-fifths (60 percent) are actively seeking acquisition targets and another 12 percent are in the process of acquiring another utility.

In terms of the number of announced or completed M&A transactions in the industry, the worldwide total actually fell in 2006. According to market research firm Zephyr, there were 883 such deals in that year, compared with 906 in 2005. However, also according to Zephyr, the total value of deals increased considerably from US\$257 billion in 2005 to US\$420 billion in 2006. In other words, the number of deals may not have increased dramatically, but the size of the deals has.

A number of major deals have recently been announced, particularly in Europe. These include Spanish utility Iberdrola's takeover of Scottish Power; German utility E.ON's bid for Spain's Endesa and the subsequent agreement with Enel and Spanish construction group Acciona; the planned merger of Gaz de France with Suez; and last year's acquisition of Thames Water, Britain's biggest water company, by a consortium led by Australian bank Macquarie.

There have also been major utility M&A deals in the U.S., including the acquisition of Cinergy by Duke Energy, the acquisition of PacifiCorp by MidAmerican Energy Holdings (both completed in 2006), and the pending controversial acquisition of KeySpan by the U.K.'s National Grid (expected to be decided in summer 2007).

In Asia, MMC Corp, a Malaysian infrastructure group, agreed to buy Malaysian power company Malakoff Bhd.; and Australia Utilities AGL (Australian Gas Light) and Alinta merged with a US\$5.1 billion asset swap.

The utility consolidation trend is making headlines on an almost daily basis. For example, in late February 2007, senior New York state regulatory officials published objections to the proposed acquisition of KeySpan by National Grid, recommending that KeySpan sell its largest power plant as a condition for the deal. Then in March 2007, Enel made a surprise bid for a 22 percent stake in Endesa, which would make Enel the biggest shareholder in the company. Days later, the German media reported that E.ON was considering buying a stake in Enel as a countermove.

Private equity firms have recently taken an increasingly visible role in bidding for and acquiring independent or soon-to-be-sold merchant generation assets. In the U.S., private equity firm Kohlberg Kravis Roberts and Texas Pacific Group announced the acquisition of Dallas-based energy giant TXU Corp, in a transaction valued at about US\$45 billion. Similarly, Warren Buffet's Berkshire Hathaway investment group bought out Midwestern Utilities, and later acquired PacifiCorp. In some cases, regulators have raised objections to private equity investors, fearing that the acquirers will try to extract maximum profit before disposing of the asset at the earliest opportunity. Earlier this decade, for example, private-equity bids for two utilities – Unisource Energy and Portland General Electric – were rejected by state regulators.

The utility consolidation trend is making headlines on an almost daily basis

In the case of TXU Corp, there has been speculation that the acquirers plan to separate the acquired utility into distinct generating, transmission/distribution and retail businesses, as a prelude to spinning off one or more of those businesses. The buyers, however, said in early March that they have no plans to spin off or sell any of the company's businesses during the five-year period they have pledged to hold TXU.

Regardless of whether acquirers are private equity groups, infrastructure funds or other utilities, experts interviewed see more such activity in the years ahead

Infrastructure funds differ from private equity bidders in that they are typically viewed as longer-term investors. For example, a consortium led by Australia's Macquarie Infrastructure Partners received approval in April for its merger with Duquesne Light Holdings, Pittsburgh's electric utility. In Asia, Babcock & Brown Power, a fund created by the Australian investment bank to invest in energy assets, bought the energy assets of NRG Flinders of Australia. Such developments have promoted others, including Goldman Sachs and Blackstone Group, to establish their own infrastructure funds.

Still, infrastructure funds do not always find a warm welcome. Babcock & Brown Power has run into opposition from citizens' groups in its US\$2.2 billion bid for NorthWestern Energy of Montana. Opponents fear the acquisition would cause their electricity bills to rise.

Regardless of whether acquirers are private equity groups, infrastructure funds or other utilities, experts interviewed see more such activity in the years ahead. "This is more than a wave, it is a tsunami," says Emmanuel Turpin, utilities analyst for Morgan Stanley, referring to M&A activity among European utilities in 2006. "I don't think we will see an acceleration in 2007 of the activity we saw in 2006, but it will continue," he says. "The M&A activity level in 2006 was part of a trend, not a freak figure."

Concerns about energy security and climate change have prompted growing interest from utilities in wind power and other renewable energy assets

M&A in renewables

Concerns about energy security, climate change and incentives from governments to bolster their investment in renewable energy sources have prompted growing interest from utilities in wind power and other renewable energy assets. "Groups such as Acciona, AES, EDF, Endesa, Enel, Iberdrola and RWE are all looking to expand their renewable generation capacity and establish a firm foothold in the market," noted Clearwater Corporate Finance's head of research, Constantine Biller, in a statement in early March 2007. In 2006, French company Theolia took over the German wind park developer Natenco, and the Spanish building contractor Acciona acquired the Spanish wind farm developer Corporación Eólica CESA.

In July 2006, AES Corp of the U.S. announced that it had acquired majority control of Wind Energy Ltd., a U.K.-based wind development company, with 640 MW of wind generation projects under development in Scotland. The company said the acquisition, the first entry of its wind energy business into Europe, "represents a strategic step in our efforts to become a leader in wind generation development and operation worldwide."

Intense interest in the renewables sector has prompted speculation that bidders could be paying too much to secure assets. In addition, because there are often a large number of bidders chasing the same deals, it has become more common for acquirers to pay a premium in return for exclusivity in the bidding process.

Investment has flowed in the opposite direction as well. In May 2006, Iberdrola of Spain said it would acquire Community Energy, Inc. (CEI), a U.S. wind energy marketing and development company based in Wayne, Pennsylvania. Ignacio Galan, chief executive of the company, said that this transaction would make it possible to "combine Iberdrola's international experience managing and operating wind farms with CEI's position in the U.S., providing it with a platform for rapid large-scale growth in the North American wind energy market."

Company growth strategies focus on M&A

Capitalizing on favorable economic and financial-market conditions

The electric power industry is on an upswing, spurred by a general improvement in the economy and growing demand for energy. The survey results bear out this sense of optimism. Some 42 percent of survey respondents expect revenue growth above 20 percent in the next three years. Another 42 percent expect growth between 11 percent and 20 percent in that time period.

The majority of respondents say that, overall, organic growth will be more important than growth by acquisition for their future strategy, although the survey also indicates strong appetite for growth by M&A. One factor tipping the scale in favor of growing through M&A, rather than through organic development, is that current financial market conditions encourage large-scale M&A.

In particular, funds are available – both from strategic buyers and from investors in general – at the same time as investment is needed in electric power infrastructure. Investment bank UBS estimates that there is US\$1.3 trillion of finance available globally to be invested in infrastructure. European utilities, meanwhile, are awash with cash – 140 billion euro, according to financial portal www.moneyweek.com – and are inclined to spend it on newly built and acquired assets.

“There is a great deal of investment money sloshing around and looking for a home,” says Richard Cortright, managing director of utilities ratings in the U.S. for Standard & Poor’s, the rating agency. “This may be driving interest in M&A more than the economics of any particular deal. A lot of investment funds are looking for a stable and predictable source of income, and utilities have traditionally provided that.”

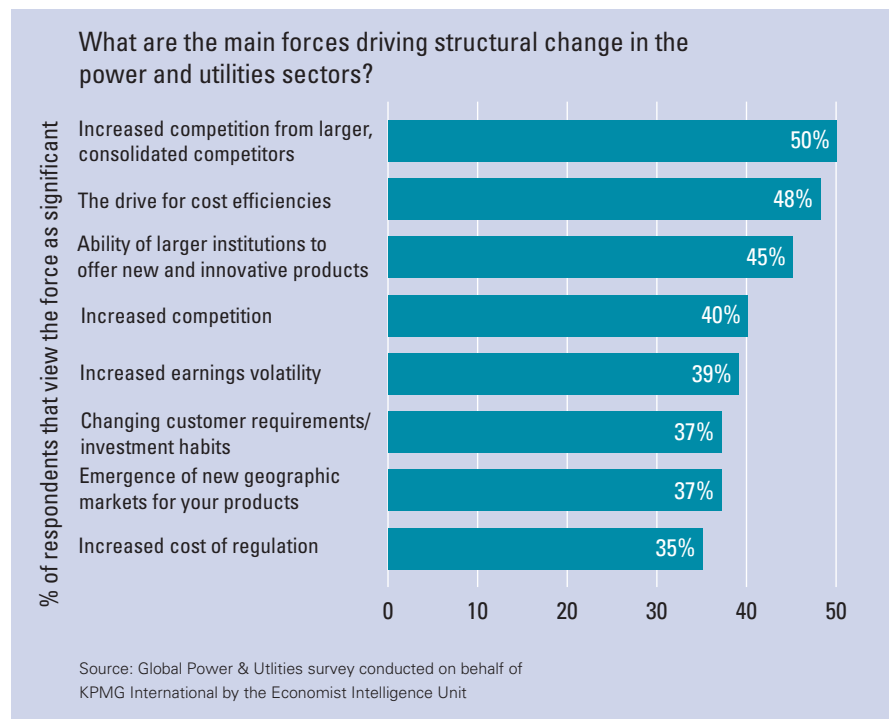
Keith Harris, director of finance and policy for Wessex Water, a U.K. subsidiary of Malaysia-based conglomerate YTL, agrees with this assessment. “Networks of pipes and wires offer a safe home for financial investors because this is essentially a cash-generative business. Also, with bond yields as low as they are, they can acquire debt of utilities at low prices.”

The electric power industry is on an upswing, spurred by a general improvement in the economy and growing demand for energy

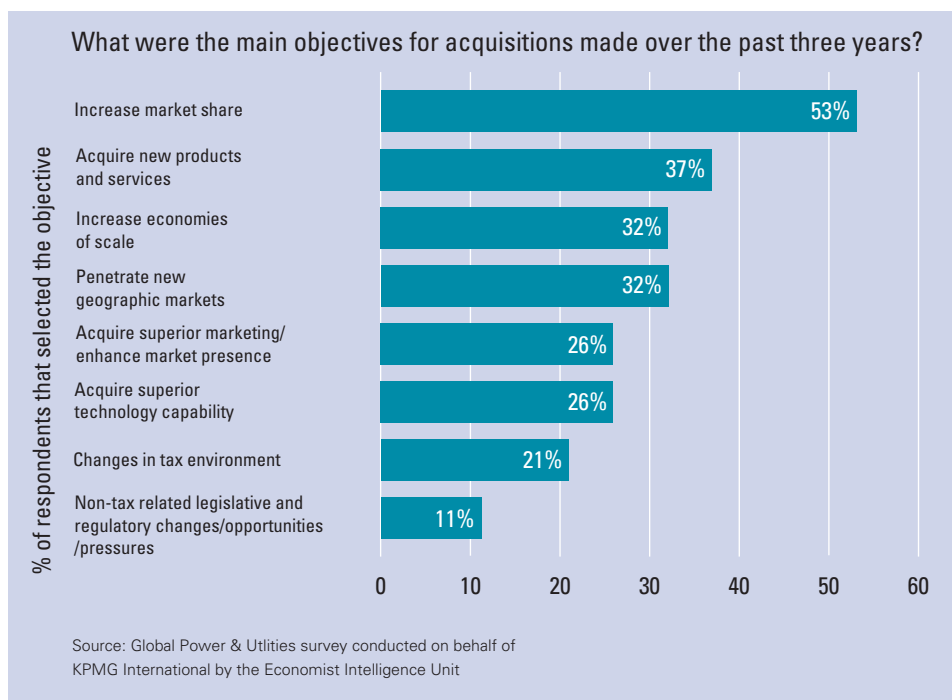
Geographic expansion – as in the case of YTL’s acquisition of Wessex Water or the interest by Germany’s E.ON of Spain’s Endesa – figures prominently in utilities’ growth plans. Within the EU, the most significant M&A activity is expected in liberalized markets such as the U.K., the Netherlands and the Nordic countries, and in growing economies such as Spain. The survey shows that when utilities look for new geographic markets, they tend to favor high-growth countries such as China, India and Russia. The regions seen as the least attractive investment destinations are Eastern Europe, the Middle East and North Africa.

Fending off competitors and cutting costs

Fending off perceived threats from consolidated competitors is much on the minds of utility executives, particularly in Europe. Half of the survey sample cites increased competition from larger, consolidated competitors as being a force that is driving structural change in the sector. Other notable drivers include the ability of larger institutions to offer new and innovative products, cited by 45 percent of respondents, and increased competition in general, cited by 40 percent.



When asked about their own objectives for pursuing acquisitions over the past three years, the chief motivator is seen as the need to increase the company's share of the overall regional (in the case of Europe) or national (in the case of the U.S.) market. More than half (53 percent) of respondents cite market share as their main objective for acquisitions, while 37 percent point to the ability to gain access to new products and services, 32 percent say the aim is to penetrate new geographic markets, and 32 percent name economies of scale.



Looking ahead to the next three years, the proportions change slightly: nearly half (46 percent) cite increased market share as the chief objective, a similar proportion cite penetrating new geographic markets and 44 percent cite cost savings through economies of scale.

The potential for mergers and acquisitions to increase cost efficiencies is a common thread that runs throughout the survey. For example, nearly half (48 percent) of respondents cite potential for cost savings as a major reason for consolidation within the sector. “Economies of scale can be achieved in front-office activities, such as finance and customer service, particularly if the merging companies are not very far apart geographically,” notes Keith Harris of Wessex Water. The same applies to back-office processes, such as customer billing and IT support.

The potential for mergers and acquisitions to increase cost efficiencies is a common thread that runs throughout the survey

In operations and maintenance, however, the potential for achieving economies of scale is more elusive, says Keith Harris. “My sense is that merging utilities cannot use the same workforces, even if they are neighbouring utilities,” he explains. “There is a lot of manual work involved in utility operations, such as digging holes in roads, and this requires the same number of guys to do the work, the same number of depots, the same number of raw material delivery operations, and so forth. It is difficult to find synergies in those operations.”

Nonetheless, some utilities claim to have found them. "When we applied for approval of our merger with Cinergy, we planned to capture roughly US\$650 million in aggregate net savings through the first five years," says Paul Barry, senior vice-president and chief development officer of Duke Energy of North Carolina, which in 2006 completed a US\$14 billion merger with Cinergy Corp. of Ohio. "We are on track to achieve those savings, and in fact have realised our work force reduction target in less than a year through voluntary retirements and attrition. We have also saved significant overheads by consolidating our corporate headquarters in Charlotte [North Carolina]."

"A merged utility redefines its borders," notes Emmanuel Turpin. "Two smaller service territories become a single larger one for operating and maintenance purposes. The management of the larger territory can be unified. The size of the fleet of service vehicles, the size of the maintenance staff, the number of technicians on call – all that can be optimized for a single territory. As for back-office operations, you need only one IT department, one finance director, and so forth."

"If a utility has a wide portfolio of assets across Europe, that creates a different perspective that local utilities do not have," says Dierk Paskert, senior vice-president for corporate development at E.ON. "For example, if a utility is deciding where to build a new plant, that question takes on a different dimension if the company is active in five inter-dependent power markets. It can start optimizing its power production and transmission in different ways, thus giving a competitive advantage against companies limited to a much smaller region."

"In addition, significant cost savings can be achieved by standardizing plant design and combining purchasing," adds Dierk Paskert. "Currently, every power plant is designed specifically for its location; and we have only seen some limited standardization with gas plants to date. This is not however necessary. It is quite possible to have a convoy strategy for new build: that is, a single design for power plants which can be used for the entire portfolio. This creates opportunities for cost savings in construction, operation and maintenance, and in negotiation with manufacturers."

Achieving strategic objectives and managing risks

In addition to fending off perceived threats and cutting costs, merging utilities try to achieve strategic benefits by matching up their respective strengths and weaknesses. “[The exact nature of those benefits] depends on the profiles of the utilities and whether those profiles complement each other,” says Jim Owen, director of communication for the Edison Electric Institute, the trade association for investor-owned utilities in the U.S.

An example was the proposed merger of FPL Group (Florida Power & Light) and Constellation Energy of Maryland, which collapsed in 2006 in the face of political opposition in Maryland. Although the merger did not go through, utility industry officials say it would have made good strategic sense. “FPL has several million customers, strong nuclear power operations, and a merchant entity that trades power across state lines,” says Jim Owen. “Constellation has a smaller customer base, but a significant wholesale marketing operation that is active in several dozen states. This merger would have diversified the risks of both utilities by matching up their respective strengths.”

Many executives cite risk management as the chief aim of M&A. Stephane Ramon, former head of M&A at Electricité de France and currently group financial controller of EDF Energy in the U.K., notes that power and gas are among the most volatile commodities on the market. As a result, many utilities are increasingly trying to become vertically integrated electricity and gas operators as a way of dealing with this unpredictability. “Many groups embark on M&A as a way to hedge their risks,” he explains. “For example, a retail power supplier may buy generation assets to hedge its risk of not having enough power to serve customers and to protect itself against price variations. Or, a utility might acquire another, more vertically integrated utility, to hedge fuel-supply risks.”

In addition to fending off perceived threats and cutting costs, merging utilities try to achieve strategic benefits by matching up their respective strengths and weaknesses

Standard and Poor’s makes a similar point in a paper published in October 2006. “Large groups such as E.ON, RWE, Enel, and Electricité de France are able to develop critical risk mitigation skills in trading, procurement, R&D and investments, as well as enhancing the ability to manage large investment projects and smooth capital expenditure profiles,” it notes. “Well-managed vertical integration allows companies to reduce risks by ensuring access to and control over important input and output factors, such as fuel supply and downstream market access.”

The shift toward gas-fired generation will require investment in gas supply, pipeline and storage infrastructure, as well as upstream production facilities

Enhancing balance sheets to enable capital investments

In Europe in particular, utilities are motivated by concerns that Russia could raise gas prices for European buyers, as it already has for customers in the Commonwealth of Independent States. They also worry that under-investment in power plants will cause future shortages in growing economies. Dealing with both concerns will require heavy investments in power plants, transmission lines, and upstream and midstream feedstock facilities.

E.ON estimates that Europe requires between 250-300 gigawatts of new generating capacity over the next 15 years, as well as new gas storage capacity, electricity inter-connectors and power transmission networks. The International Energy Agency calculates that Europe's energy investment needs a total of US\$1.75 trillion for 2005 to 2030.

The shift toward gas-fired generation will require investment in gas supply, pipeline and storage infrastructure, as well as upstream production facilities costing 95 billion euro to 110 billion euro by 2012, according to Standard & Poor's. It notes that, in addition to building new gas-fired generating plants, major European utilities are increasingly moving into the upstream sector, investing in natural gas production, storage and liquid natural gas import facilities. Some are also considering diversifying into nuclear power.

Utilities therefore require considerable strength in their balance sheets to foot the bill. This is a significant driver for M&A in the U.S. as well, says Paul Barry of Duke Energy. "There are hundreds of billions of dollars of capital requirements in the U.S.," he says. "The whole industry is seriously under-invested, and a fragmented industry is not in a good position to make these investments."

Duke Energy, for example, plans approximately US\$3 billion in capital expenditures in 2007, including building new coal-fired and nuclear plants. "Our merger with Cinergy helped to produce the kind of balance sheet we need to support that level of capital expenditure," says Paul Barry.

Responding to deregulation – The EU perspective

A significant factor in the drive for consolidation in Europe is the planned full deregulation of the EU energy market, which formally takes effect on 1 July, 2007. The European Commission's aim is to enable energy producers and distributors to compete freely across national borders. This threatens the lock that incumbents have had on their domestic markets, and European utilities are responding by seeking to build regional powerhouses that can withstand such incursions into their home markets.

...the European Commission's aim of a borderless energy market is expected to materialize gradually in the years ahead

Although incumbent utilities in some states, including Germany, have a strong hold on their domestic markets, and poor grid interconnections between states will slow EU market integration, the European Commission's aim of a borderless energy market is expected to materialize gradually in the years ahead.

"We expect that, by the end of this decade, most power markets in the EU will be liberalized, and this is definitely a factor in our decisions," says Dierk Paskert of E.ON. "We expect we will always face some regulation at the national level but, at the EU level, there is a drive to put a market structure in place, and that makes it more likely that utilities can realise their full potential by competing in a pan-European market."

Emmanuel Turpin of Morgan Stanley agrees. "We are seeing a big shake-up of a century-old industry," he says. "Nothing much happened for the first 90 years or so, but now that EU liberalization is being put in place, and fair competition is the order, we see more M&A activity."

The EU has a long way to go, however, to achieve a de facto single market in electricity. One of the main reasons why actual market integration is likely to lag some years behind the official deregulation is that interconnections between national grids are often poor. "This makes it difficult to achieve synergies if a utility acquires a geographically remote company," notes Stephane Ramon of EDF Energy. "It may take a pretty long time to fully integrate the European power market. At that point only a handful of truly European players will remain. It is quite easy to see who that might be: two German utilities, one or two French utilities, maybe one from Spain and maybe one or more of the purely gas operators."

Unlike in the U.S., utilities in Europe are already consolidated at the national level. As a result, the current wave of cross-border M&A could create super-giants. This has not escaped attention in the U.S., where the market is much more fragmented. "If the E.ON-Endesa merger goes through, that company will have four times the market capitalization of Duke Energy, even after our merger with Cinergy," notes Paul Barry of Duke Energy. "Europe has some true titans in the market, much more so than the U.S.. We ask ourselves where those European companies might turn for acquisitions, once they have consolidated within Europe. Might they look to the U.S., as have National Grid and Scottish Power?"

Unifying a fragmented industry – the U.S. perspective

In the U.S., deregulation is a much less significant driver of consolidation than it is in Europe. A move during the 1990s by the Federal Energy Regulatory Commission (FERC) to introduce retail power deregulation in all 50 states ran aground when California electricity markets failed in 2000-2001. Regulation is still firmly in the hands of state officials; this impedes efforts to merge utilities across state lines and to form a seamless national retail power market.

The repeal of the U.S. Public Utility Holding Company Act (Puhca) in 2005 theoretically removed impediments that this 1935 law had placed in the path of interstate utility mergers. But in fact, according to utility experts, the repeal has had the effect of transferring more oversight responsibility over proposed mergers from federal to state officials. The expanded role of state regulators makes regulatory risk one of the first areas a potential acquirer must assess when looking at a target.

A recent example is offered by New York State regulators in the proposed acquisition by the U.K.'s National Grid plc of KeySpan Energy. In late February 2007, senior staff members of the New York State Public Service Commission said the deal should be rejected unless National Grid agrees to consumer protections and sells its largest power plant to prevent market manipulation. The merger proposal is expected to be decided in summer 2007.

At present, 18 states allow competition in retail power markets, and the rest do not, notes Jim Owen of the Edison Electric Institute. "Since the California market imploded, no other state has made any move toward retail competition. We are in a long-term hybrid regulatory model at the state level for retail power markets. Wholesale markets, in contrast, are fully competitive; that is the law of the land."

In the U.S., deregulation is a much less significant driver of consolidation than it is in Europe

This fragmentation of the U.S. power industry creates the potential for achieving economies through M&A. Over the past 15 years, since the FERC originally launched its deregulation drive, the number of investor-owned utilities in the U.S. has shrunk from 100 to 70, mainly as a result of M&A. "However," says Jim Owen, "this industry is still under-concentrated relative to other network industries. Compare utilities with other large network infrastructure industries: there are now only three or four railways, only two or three telephone companies, and a shrinking number of airlines. Those industries consolidated because mergers offer synergies and economies of scope and scale, and the same applies to the electric power industry."

Rapid economic growth in the most populous countries in the region, notably China and India, is creating large organic growth opportunities

Paul Barry of Duke Energy agrees that there is scope for further consolidation. “There is an opportunity for two or three large U.S. utilities to merge, thereby creating a company with a market capitalization of US\$50-75 billion – which starts to rival the size of an E.ON-Endesa combination, which is almost US\$100 billion, if that merger goes through. I expect to see three to five merger deals announced among U.S. utilities in 2007, and another three to five in 2008 not exactly a flurry of activity, but it would represent steady progress.”

Australia seeks overseas opportunities – the Asia-Pacific perspective

Rapid economic growth in the most populous countries in the region, notably China and India, is creating large organic growth opportunities. Market entry and expansion strategies, together with funding requirements, are also driving M&A activity in these markets.

By contrast, in more mature economies in Asia-Pacific, utilities are re-inventing themselves in response to unprecedented changes in the business environment. In the case of Australia, liberalization and privatization have allowed a number of companies to increase scale, diversify geographically and integrate competitive parts of the industry.

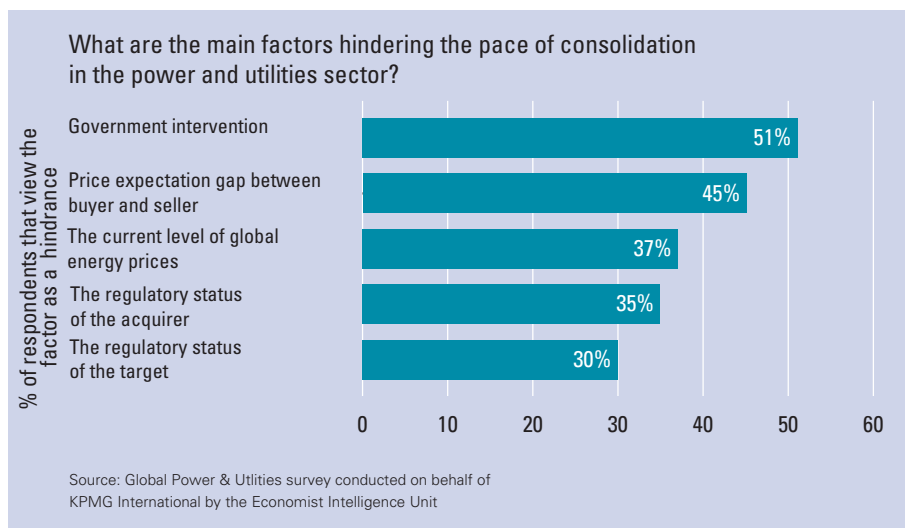
Recent M&A trends have seen specialization in either regulated or competitive sectors of the industry, consolidation within the respective sectors and the entry of Asian-based companies seeking geographical expansion.

Australia has also become a major investor in other countries as its large and rapidly growing pension system increasingly seeks offshore investment opportunities.

Looking ahead, many of the fundamentals for continuing high levels of M&A activity in the power and utilities sector remain in place, with strong demand for new investment, high investor appetite and further government reorganization leading to privatization opportunities.

Politics and asset-price inflation can slow the pace of consolidation

While the consolidation trend has strong drivers, it is held back by several inhibiting factors. Survey respondents cite government intervention (51 percent) and the price expectation gap between seller and buyer (45 percent) as the main factors slowing M&A. In cases where acquisitions were planned but not completed, the reasons are most likely to be the seller's high price expectations (35 percent), a decision by the buyer that synergies would not be realised (33 percent) or that the target is too risky (30 percent).



Regulatory obstacles

Regulatory interference can be a major factor impacting the level of M&A activity in the sector. On both sides of the Atlantic, state and national regulators have impeded acquisitions of utilities by overseas companies. France, for example, pre-empted a bid by Italy's Enel for French utility group Suez by encouraging a merger between Suez and Gaz de France. Spanish regulators issued a long list of conditions for the proposed acquisition of Endesa by Germany's E.ON – a list that European regulators subsequently ruled illegal.

In the U.S. in 2006, Maryland state regulators blocked the acquisition of Constellation Energy by FPL Group, and New Jersey regulators rejected the proposed acquisition of PSEG by Chicago-based Exelon. "In general, it is very hard to consummate utility mergers in the U.S.," says Paul Barry of Duke Energy. "Some regulators object to the idea of having decisions regarding their service territories made in a different state."

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The U.K.'s National Grid plc has direct experience with multi-state regulation in the U.S., having acquired the New England Electric System and bid for New York and New England-based KeySpan Energy. "[Multi-state regulation] increases the time required for acquisitions to be approved," says Humza Malik, director of group strategy and corporate development for the company, "but we have had positive and constructive relations with U.S. regulators."

Another inhibitor of consolidation is the gap between sellers' and buyers' price expectations

Asset-price inflation

Another inhibitor of consolidation is the gap between sellers' and buyers' price expectations. The widespread belief that consolidation will continue has driven up sellers' prices. According to Global Power Report, Paolo Pallotti, head of M&A at Enel, told a recent industry meeting that the biggest challenge facing acquirers is to avoid overpaying in an over-heated market. "The market has put pressure on companies to indulge in M&A," he said. He warned that, in the wind sector in particular, there is strong pressure to buy assets (see box on renewables on page 8).

Sometimes buyers resist the pressure. "The transmission assets that we have seen become available in Europe are either small and fragmented, or they are priced too high," says Humza Malik. Instead, the U.K. utility turned to the U.S. for acquisition targets.

"Whether utility mergers make good financial sense is more a question of the financial discipline of the buyer than a general statement for the sector," says Dierk Paskert of E.ON. "As we showed in the Scottish Power case, the price can sometimes be too high. Indeed, we walked away from that deal because the price we were being asked to pay did not make sense, given our evaluation of the business."

Doubts about cost savings

Concern about the extent of synergies that can be achieved also has a dampening effect on M&A activity. A subject of frequent debate is whether the power utility industry – whose product cannot be stored and is produced comparatively close to the final consumer – benefits from the same economies of scale that apply to mass-produced and mass-distributed goods. Research firm Datamonitor, for example, found no statistically relevant relationship between the size of a utility, measured by either revenue or the volume of energy sold, and profitability, measured by return on sales.

Proponents of M&A argue that economies of scale emerge in the management of fixed assets as utilities become larger. But Datamonitor found no statistically relevant relationship between the amount of fixed assets and return on fixed assets across a sample of 100 European utilities.

Concern about the extent of synergies that can be achieved also has a dampening effect on M&A

In the U.S., the American Public Power Association (APPA), which represents municipally owned utilities, also disputes the efficiency claim for utility mergers. In its 2005 study *The Post-Merger Experience*, the APPA says that most utility mergers are unsuccessful because of overestimation of benefits and underestimation of the difficulties in integrating the merged firms. "Predicted scale and scope economies are realised when small utilities merge, but larger utilities are not as successful in realising efficiency gains," says the APPA. "When both of the merging firms are producing the same product, it is much more difficult to streamline operations and achieve production scale economies."

Our background

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