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The oil, gas & energy sector

All the Rage
investors' appetite for new
last year. Below, annual flo
into these funds world-wide

SPECIAL REPORT

Global utilities investment trends

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The global power utility sector landscape has witnessed a significant shift in recent years. The global players of the 1990s have scaled back their far reaching portfolios and have re-directed capital toward creating larger regional footprints. M&A activity has grown sharply in America and Europe over the past five years, while significant organic growth is occurring across Asia and the MENA region. Each of these regions has unique factors driving sector activity and unique barriers to continued development. Overall, however, sector reform measures and regional consolidation have driven recent trends.

North America

The past two years have seen a sharp rise in the number and size of M&A transactions within the US power sector. The industry has recovered from the excesses of the 1990s: companies have sold off non-core assets and exited unprofitable markets, balance sheets have been restored, and utilities are now looking to employ surplus cash. Last year saw announcements of a number of multi-billion dollar transactions including the mergers of Exelon with PSEG, Duke Energy and Cinergy, MidAmerican with PacifiCorp and FPL Group with Constellation. This trend however has not been trouble free; public opposition and regulatory uncertainty have led very recently to the cancellation of both the Exelon/PSEG and FPL/Constellation mergers.

Another key driver of M&A activities has been the repeal in early 2006 of the Public Utility Holding Company Act (PUHCA) of 1935. The move has reduced barriers to the acquisition of non-contiguous assets and simplified approval processes, which has attracted new capital and further spurred consolidation. Thus far in 2006 there have been more than ten deals of greater than \$500m, valued altogether at over \$17bn. Given the industry size and the number of local and regional utilities, the outlook for continued consolidation remains strong.

Latin America

Power sector reform throughout much of Latin America has moved slowly. Politics and the difficulties of subsidy reduction remain as serious challenges. Power demand growth forecasts across the region however are strong, in particular as many countries seek to revive economic growth. There are even fears that some markets could face serious power blackouts if the sector does not attract significant new investment.

Europe

Europe has been the most active region globally in terms of the size and value of transactions over the past two years. EU-mandated deregulation is driving acquisition activity, notably as the mid-2007 target for full sector opening approaches. Aggregate transactions of \$100bn in 2005 tripled that of 2004 and average deal sizes doubled to nearly \$500m as national utilities attempt to become regional giants. Some of the largest proposals, however, are being catalysed – and challenged – by nationalist protectionist tendencies. For example, the proposed merger of French Suez and Gaz de France was spurred by a cross-border bid for French Suez from Enel of Italy. The proposed merger of Endesa and Gas Natural of Spain has been stymied by a competing bid for Endesa from Germany's E.On. These have set off intense national debates and have kept EU competition regulators busy. Further east, privatisation

efforts in the FSU states are being driven by EU accession targets, and in Russia, state power monopoly RAO-UES is being reorganised in accordance with planned full market liberalization by 2009.

Middle East and North Africa

The landscape for power development in the MENA region is characterised by rapid population and power demand growth, large state ownership, and significant price subsidisation. Strong petroleum pricing is providing sovereigns with capital to develop needed infrastructure, and piecemeal efforts at privatisation and economic incentives have spurred private investment. Large government financed projects under development include the \$3bn GCC Power Grid which aims to build interconnected transmission between the GCC countries, and the Dolphin gas pipeline project which will deliver natural gas from Qatar to the UAE, Oman and Pakistan. The most significant private capital has been directed toward independent water and power project (IWPP) deals. Examples include bids by Suez Tractebel and Marubeni for IWPP projects in Oman, and by an international consortium on a \$3bn IWPP project in Saudi Arabia. As well, Qatar recently awarded a 40 percent stake in a 2,000 MW power plant to Marubeni for \$2.3bn, and the UAE has recently called for bids on a number of power projects.

Asia Pacific

The total value of power sector deals in Asia rose to over \$15bn in 2005 from \$6bn in 2003. The largest transactions have involved the \$1.9bn takeover by two Indian companies of the previously Enron-owned Dabhol assets, and the \$1.6bn purchase by Hong Kong's CLP holdings of SPI Australia's power assets. Over the past couple years significant new capital has been raised via IPOs in Singapore and Hong Kong, and through Australian infrastructure funds active in the region. Australia has witnessed sector consolidation as natural gas retailer Alinta recently won approval for its \$6.8bn purchase of the country's largest power utility (AGL Energy). While India and China are the two fastest growing markets in Asia, investment opportunities are limited by many of the same challenges faced in the MENA region, and the majority of investment under way is largely funded by state owned entities.

Conclusion

The frenzy of private investment in emerging market power utilities of the 1990s has tapered off. Capital is now being redirected to the creation of larger regional utilities, notably in Europe and North America. Regulatory environments have supported and should continue to sustain these trends. Strong demand growth across the MENA region is demanding significant investment, much of this supported by government budgets and high oil prices, with private capital being drawn in selectively on a project basis. Asia is seeing both M&A and greenfield investment. Investors are finding strong growth and reliable return opportunities across the global utilities sectors; liberalised capital markets, the emergence of private equity and evolving regulatory regimes should continue to benefit the sector. ■

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