U.K. Power Firms See Continental Predators --- A Decade of Privatization Leaves British Utilities Vulnerable

By Andrea Chipman
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LONDON -- Britain began to liberalize its electric-power industry in the late 1980s, years ahead of continental European countries, and introduced a heavy dose of competition into the market.

So are British utilities, toughened by years of scrapping for business, ready to conquer the sleepy European power companies that have been sheltered from competition? Hardly.

As Europe's power companies begin to pursue more big cross-border deals, such as Electricite de France's current bid with Fiat SpA to buy Italy's Montedison SpA, the British firms are looking small and vulnerable.

The industry's five main European "predators" -- Germany's E.On AG and RWE AG, Italy's Enel SpA, Spain's Endesa SA and France's Suez -- together have about 109 billion euros in their war chests, according to a report by UBS Warburg. That is more than the market capitalization of the entire U.K. utility sector, including electricity, water and gas companies.

"All U.K. energy companies, to a greater and lesser degree, could be seen as takeover targets, given the scale of the Europeans," says Ross Sayers, executive chairman of Innogy PLC, a British power generator and trader and "multiutility," supplying electricity, natural gas and other products such as telecommunications services and insurance.

Among the most vulnerable to takeovers by foreign giants are Innogy and International Power PLC, analysts and industry executives say. Although two Scottish utilities, Scottish Power PLC and Scottish & Southern Energy PLC, are among the country's largest and have been viewed by many as predators in their own right, each could be attractive to a larger rival as well.

Other British power companies already have been picked off. In April, for instance, E.On agreed to pay GBP 9.4 billion to acquire Powergen PLC, a Coventry, England, power generator, trader and multiutility supplier. Electricite de France purchased London Electricity, a smaller regional power supplier, for GBP 1.9 billion in 1999 to gain a foothold in the U.K.

When the British government privatized power companies, the idea wasn't to make them tempting morsels for Continental rivals. Rather, the goal was to make the companies more efficient by forcing them to compete for market share, thereby lowering prices.

"The consolidation that has happened in Spain and in Germany has not been allowed to happen [in the U.K.] because regulators generally prized creation of competition above creation of national champions," says Andrew Wright, U.K. utilities analyst at UBS Warburg in London.

Before privatization, one large non-nuclear generator and transmission company, the Central Electricity Generating Board, and 12 regional supply and distribution companies dominated the English and Welsh markets. Two integrated generation, distribution and supply companies -- Scottish Power and Scottish Hydroelectric, later Scottish & Southern Energy -- took care of power needs in Scotland.

In 1990-91, the British government privatized its transmission system as National Grid Co., and divided its non-nuclear power plants between two companies -- Powergen and National Power -- which were sold in two tranches. The companies were quick to move into developing markets in Asia and Latin America, where National Power later ran into trouble, but were blocked from expanding at home.

As the government put more emphasis on competition in the mid-1990s, regulators set price caps and forced companies to spin off some generating capacity. At the same time, the government privatized regional firms that supply electricity to households, and some of those were sold to foreign companies.

The combination of regulatory pressure, intensifying competition and shareholder scrutiny created a fluid and fragmented domestic industry in which the smallest companies sometimes changed hands more than once and foreign companies were often the buyers. The result is a U.K. sector made up of five large generator-retailers, two independent power producers and several smaller power-supply companies.

Meanwhile, on the Continent, governments in Spain and Germany allowed a far greater degree of consolidation in their industries, leading to the growth of behemoths such as Endesa and E.On. In both Italy and France, electricity markets are dominated by a single large player -- Enel in Italy and state-owned EdF in France -- each of which benefited from the lack of competition while building up profits to spend on overseas deals.

"I think originally, there was a sort of hope that the U.K. would be able to export its free-market competition policy to Europe," says Stewart Gray of consultancy Wood Mackenzie in Edinburgh, Scotland. "The irony is that competition in Europe has proceeded much faster than people in the U.K thought back in 1995, but also the speed of European utilities' response to it has been much faster."

Forced to balance between enabling its companies to compete in a pan-European framework and preventing them from taking a dominant position at home, Britain chose the latter, says David Crane, chief operating officer of independent power-plant operator International Power, one of two companies to emerge from last year's breakup of National Power. "The conventional wisdom was that the perfect balance between competition and scale was to have five competitors, each with 20% of the market, and effectively at the beginning of privatization the U.K. had a duopoly in Powergen and National Power," he says. "Did [the government] overshoot the mark [by creating too many competitors]? It would appear so."

Over a decade of free markets, British companies have become skilled at milking better returns from power plants, trading surplus electricity and other products and selling a variety of services to consumers, making them particularly valuable to European companies that lack such experience, analysts say.

U.K. companies also have experience with U.S. markets -- Scottish Power's purchase of Portland, Oregon-based Pacificorp and Powergen's acquisition of Kentucky-based LG&E Energy are two such examples -- making them more appealing to Europeans eyeing North America. Companies like Innogy and International Power have skills and technology that could make them attractive partners for European rivals. Innogy, for instance, has a potential gold mine in its Regenesys fuel-cell technology, which enables electricity to be stored.

Innogy executives play down the likelihood that they will be swallowed imminently by a larger rival, saying they see the company as one of the "four or five" large players that will emerge from the current round of consolidation within the domestic industry. "We're not looking over our shoulders," says Chief Operating Officer Brian Count.

International Power's focused power-generation business makes it an unlikely first choice for European companies, many of which are paring down their generation assets and looking to import less-familiar skills such as trading and retailing. Still, its diminutive size, rapid rate of expansion and strong position in lucrative U.S. and Australian markets could attract large European or U.S. independent power producers.