

THE LAST WORD

A powerful conundrum

Power company executives and energy policy-makers can be forgiven for any confusion over the strategic implications of recent developments in their business environment. While the impact of the Enron collapse on power prices was limited, the company's implosion resulted in unprecedented publicity for the energy industry and took a significant financial toll on many merchant power companies. For example, executives at AES Corp. were unable to halt the slide in their company's stock price, which plummeted from a 52-week high of near \$60 to under \$5. In recent market activity, only American Electric Power Co. and Duke Energy among the top 13 merchant power companies have weathered the downdraft; Calpine, Dynegy, Mirant, and Reliant Energy were all at or near 52-week lows at the end of February. Many of these companies are now shopping assets to raise cash and shed debt.

Merchant power companies are facing flat power prices going forward, a perceived glut of new generating capacity, and a renewed level of regulatory and legislative scrutiny that can hardly be welcome. Now, many executives must also re-evaluate some of the most basic precepts of their business operations and organization.

Senior executives at Enron developed and touted their centralized, asset-light, trading-heavy business model. AES, on the other hand, has a decentralized, asset-heavy, trading-light model. Arguably, AEP and Duke are in a centralized, asset-heavy, and trading-heavy position, so perhaps the market is judging this to be the correct business model for electric power. But isn't this just the return of the vertically integrated company?

The winner—and still champion

Indeed, various Wall Street analysts and bankers quoted in a recent trade press article were speculating that the market "winners" will be none other than the old-line utility holding companies, now beefed-up after a decade of acquisitions and market consolidation. In the U.S., such names as AEP and Duke (again) are mentioned, along with FirstEnergy, Dominion, FPL, Southern Company, TXU, and big European companies like E.ON, RWE, and Tractebel.

Declining stock valuations are certainly a sign that the "market" operates as it should, digesting company results, and rewarding the winners with higher or at least stable stock prices. For power company managers and executives, a reasonable interpretation of events over the last six to eight months seems straightforward. Keep the company attuned to the basics with a judicious mix of hard assets, reliable sales of large amounts of energy "product," less financial creativity, and more centralized accounting and operational oversight.

For energy policy-makers, one of the biggest questions is one of the simplest: How are power generators and transmission companies to be compensated with a "living wage" that will support needed capital investment going forward?

BY CHRISTOPHER BERGENSEN

In the idealized deregulated era, the main electricity producers were to be merchant power companies. Consumers would benefit as prices were relentlessly pushed towards the marginal cost of production and intermediaries competed for their business. This has happened in some instances (and not in others), but, as has now been amply demonstrated, there is little margin for error. If there are market perception issues, accounting irregularities, currency exchange rate volatility, unexpected inflation or deflation, local or national political problems, or almost anything out of the ordinary for extended periods, the results can be serious cash-flow problems, a rapid and catastrophic stock price collapse, and bankruptcy.

In 1882, Thomas Edison's Pearl Street power plant in New York City ushered in the era of central-station electricity production. It seems remarkable that the rationale for the essential conservatism of heavy industrial companies has so often been forgotten or overlooked since then—and this is particularly true in electric power. The vertically integrated model provided electric service reliably and at an affordable price, and industry participants maintained a workable and moderately orderly investment planning process. During a century of tremendous technical innovation and system expansion, electricity became the most widespread and versatile of all energy sources.

For a variety of good reasons, policy-makers around the world were persuaded to encourage or require the restructuring of the electric power sector starting about 20 years ago—just about 100 years after Pearl Street went on line. On balance, the effort seems to have been worthwhile, but after Enron, many people are wondering what business model will win out in electricity's second century—asset-light or asset-heavy, centralized or decentralized, trader or producer, vertical or unbundled? Stay tuned. ■