FOR STRAIGHTFORWARD, PRAGMATIC REASONS, SAY OBSERVERS, THIS MERGER TREND WILL CONTINUE FOR QUITE A WHILE.

MORE AND MORE MER

BY DENNIS J. WAMSTED

The boundaries of the electric utility industry are being redrawn—both literally and figuratively—as company executives seek to position their firms for an uncertain future. In the past 18 months alone, nine major deals valued at roughly $72 billion in stock, debt, and cash have been announced, and financial industry executives and utility consultants say more are on the way. While in some ways part of a continuum of change that began in the 1990s with the onset of competition, industry experts say the recent deals are different—they represent a new approach. What the industry's new boundaries will look like in five years is anybody's guess, they added, but one thing is certain—that landscape will look entirely different from today's.

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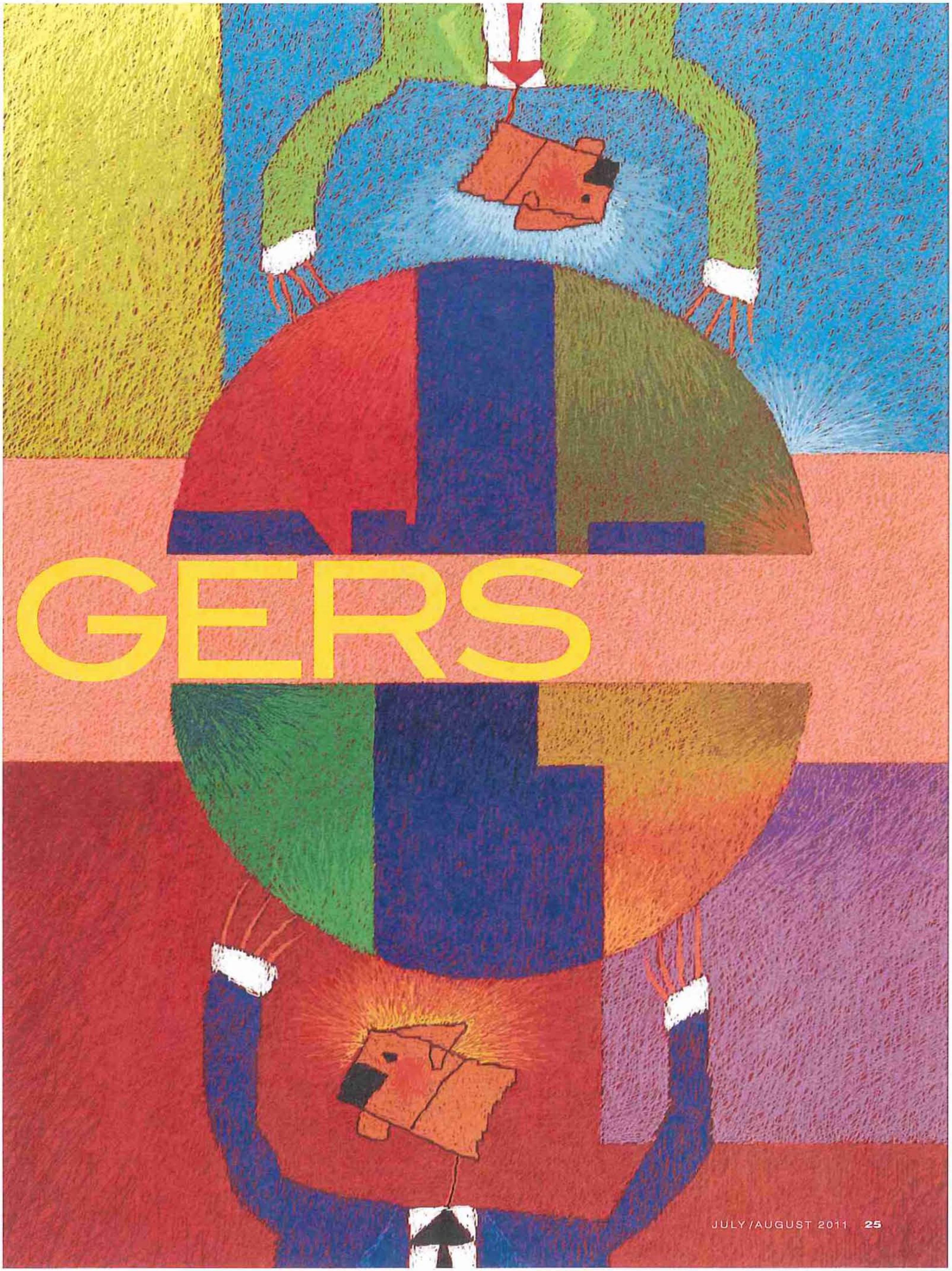
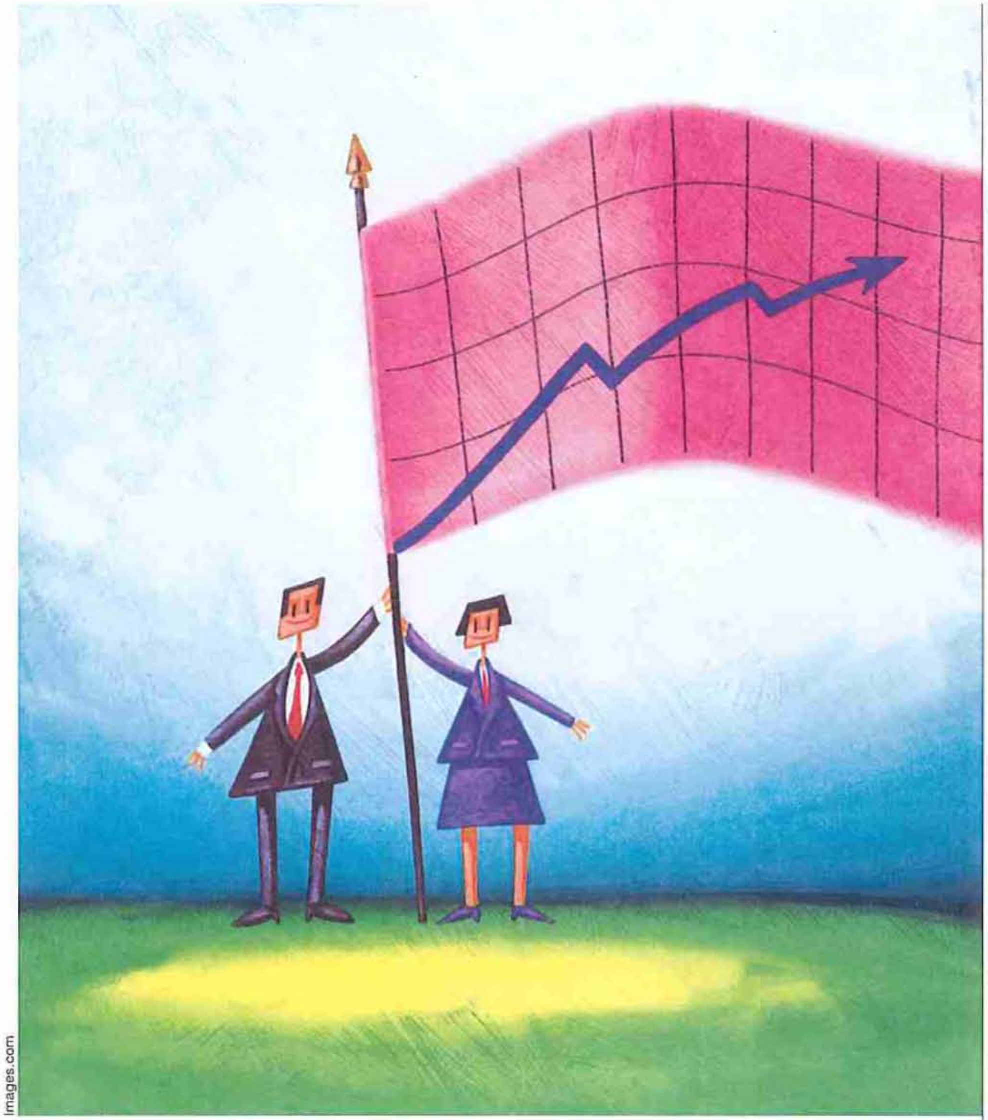


GERS

What is particularly striking is the breadth of the current utility interest in M&A. It is not just the largest companies looking to combine; it's a pretty good bet that virtually all companies are studying their options. That breadth has already shown up in the pending deals, from Canadian-based Fortis' planned purchase of Central Vermont Public Service for roughly $700 million to the mega-merger between Duke Energy and Progress Energy, under which Duke would buy its smaller North Carolina neighbor for just under $14 billion, creating the largest utility in the United States.

That across-the-board merger interest is almost certain to continue in the near term, one Wall Street executive said, predicting that there likely will be

- a couple of other mega-mergers, which he defined as combinations of companies with market caps above $10 billion;
- "a lot of natural mergers of equals" among mid-size companies, with market caps between $2-$10 billion; and
- continued consolidation or buyouts among companies at the lowest end of the spectrum, with market caps below $2 billion.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MANY INDUSTRY ANALYSTS EXPECT THAT BALANCE-SHEET MERGERS WILL BECOME INCREASINGLY COMMON AMONG UTILITIES IN THE MIDDLE OF THE SIZE SPECTRUM.

The other notable feature of the current round of consolidation, say financial analysts and consultants, is that each deal is different. There is no "me-too" frenzy under way in which mergers are proposed simply to keep up with the Joneses. Big as it is, the Duke-Progress merger is, at its heart, basically a combination of regulated neighboring utilities that likely will yield significant cost savings, just as predicted. On the other hand, PPL's recent deals—it bought E.ON's regulated U.S. operations and a U.K. utility—have turned the company inside out. From being highly exposed to the unregulated market, PPL now says the vast majority of its future earnings will come from regulated operations. Finally, the Northeast Utilities-NSTAR merger is a classic example of mid-range utilities looking to get bigger.

What this shows, say observers, is that the current M&A round is grounded in good business sense and likely will persist. "We continue to expect more combinations, but at a measured pace," one Wall Streeter said. Added Tom Flaherty, a senior partner at Booz & Company: "There is plenty of room for more consolidation."

You can trace that business grounding directly to the 2008 credit crisis and the ensuing recession. Before the credit crunch, utilities nationwide enjoyed relatively easy access to capital and were gearing up for what the industry expected to be a major infrastructure-building effort to replace aging generation and keep up with rising demand. One important aspect of the effort was that infrastructure investment would also augment companies' installed rate base, allowing them to make money the old-fashioned way—through internal load growth. That is decidedly no longer the case. Now, with the sharp drop in electricity demand during the recession (overall retail sales in 2010 were still below the total notched in 2007, before the economic problems began), more difficulty accessing the capital markets, and expectations for only slow load growth, utility executives are rethinking their strategies.

A Better Balance Sheet

The planned merger between Duke Energy and Progress Energy surprised

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some when it was announced early this year, but it makes perfect sense, according to many analysts. It is a megadeal, acknowledged one Wall Street executive, but that is all that sets it apart from an old-school utility merger where the benefits largely derive from cost savings wrung from the operation of one company instead of two. In the Duke-Progress case, for example, the company estimates that it will be able to cut fuel-related costs by almost $700 million from 2012 to 2016, with slightly more than half coming from efficiencies gained through a planned joint dispatch agreement. In addition, the companies expect to cut non-operations-and-maintenance spending by at least $300 million annually.

Those savings, coupled with a stronger balance sheet, are vital for the future, according to Jim Rogers, Duke's current chairman and CEO who will become executive chairman of the combined company. Growth has slowed in the companies' service territories, but the two utilities still have more than $5 billion in generation investments planned to replace aging plants and keep pace with new demand. Other major cost increases could arise, depending on the outcome of several rulemakings from the Environmental Protection Agency.

By merging, Rogers said in written testimony filed at the North Carolina Utilities Commission, the companies will be able to maintain access to capital at the lowest possible cost and mitigate the impact of future cost increases due to the ongoing construction work. Further, by combining their balance sheets, the companies, which already operate a total of 12 reactors, will be better able to pursue future nuclear expansion activities without "betting the company" on the outcome. The combination also will lower the companies' risk profile—after the merger 88 percent of the company's activities will be in fully regulated activities (and in states with relatively receptive commissions) versus 79 percent currently for Duke Energy.

Such mergers make sense in other areas of the utility size chain. Indeed, many industry analysts expect that balance-sheet mergers will become increasingly common among utilities in the middle of the size spectrum. Here, the merger of NU and NSTAR could serve as a model.

The combination, announced in October 2010, would create a New England utility major serving roughly 3.1 million electric customers—about half of all ratepayers in the region. In announcing the deal, Chuck Shivery, the current chairman, CEO, and president of NU, and Tom May, chairman, CEO, and president of NSTAR, spoke openly about the importance they attributed to the additional scale the companies were gaining through the merger.

Strategic Thinking

Says a recent Citi report on consolidation in the utility sector, "Investors are responding favorably to well-reasoned, growth-oriented combinations with 'core' businesses as the investment thesis." (See Table 1.) It also notes the CEOs are "more inclined to think about strategic alternatives as they consider repositioning for longer term sustainable value." As a result, in recent mergers, CEOs "proactively called their preferred partners, struck deals, and defended their mergers from topping bids." Citi expects that trend to continue.

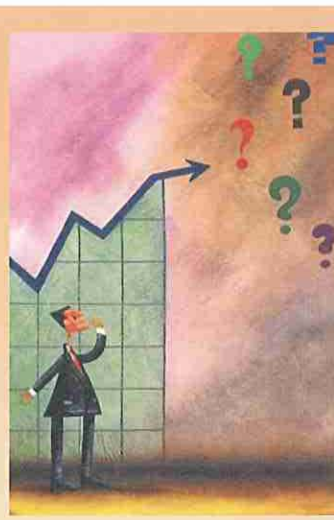
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TABLE 1

MERGERS AS A DE-RISKING TOOL

Recent mergers and their benefits

Exelon-Constellation Energy Group
- Provides mix of clean generation to Exelon's portfolio.
- Enhances Exelon's competitive generation margin and expands a channel to market its generation.

AES-DPL
- Expands AES's U.S. platform and captures value associated with the company's U.S. tax position.
- Leverages AES's global resources and expertise.

PPL-E.ON U.S./E.ON Central Networks (U.K.)
- Decreases PPL's commodity price exposure.
- Regulated operations strengthen credit profile.
- Dividend backed by more stable earnings base.

Duke Energy-Progress Energy
- Dilutes Duke's Ohio/Indiana regulatory concerns.
- Provides significant rate-base growth.
- Provides more stable, predictable earnings and cash flows.

AGL Resources-Nicor (natural gas)
- Offers leadership position across natural gas value chain.
- Creates significant regulatory diversity.
- Enhances scope and scale.

Northeast Utilities-NSTAR
- Eliminates external financing needs due to excess NU free cash flows.
- Provides significant rate base and transmission growth.

Calpine-Conectiv Energy
- Eliminates commodity price exposure.
- Helps de-lever Pepco Holdings.
- Enhances PJM presence and natural gas leadership.
- Provides growth opportunities for Calpine.

FirstEnergy-Allegheny
- Covers short position in FirstEnergy portfolio.
- Produces cost savings that supplement internal cash flows.
- Enhances purchasing power, scope, and scale.

Source: Citi

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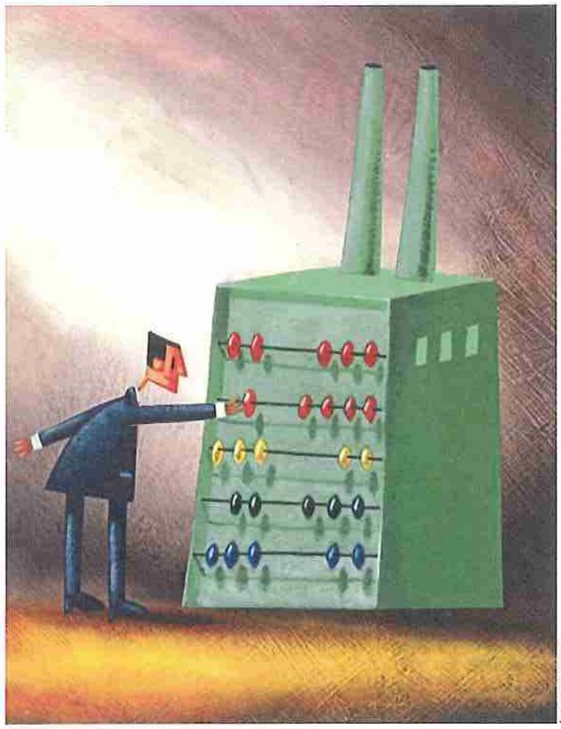

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BE REALISTIC, BOTH ABOUT WHAT YOUR OPERATIONS ARE WORTH AND ABOUT THOSE OF ANY COMPANY YOU CONSIDER BUYING.

"Scale is important; it does give us the opportunity to do so many more things, we think not only of a nature that's going to benefit our customers, but of a nature that clearly benefits our stockholders," Shivery told analysts.

May added that the larger "footprint" of the combined company will give it the ability to tackle projects that previously would have been cost-prohibitive.

The merged company also will be able to "play a larger role in energy policy in New England and, quite frankly, energy policy on a national scale than either one of us could have before," Shivery continued. "That ultimately translates into more economic growth, which ultimately translates into benefit to our shareholders."

It is important to note that the additional size will not come at a premium. In announcing the deal, both May (who will become president and CEO of the merged entity) and Shivery stressed that there was no premium associated with the $9.5 billion stock-for-stock deal.

Other recent utility deals, while not zero, have also been characterized by relatively low premiums—and for analysts studying the industry that is a key factor, one which sets the current round of consolidation apart from previous merger cycles.

Learning from the Past

"We do think it is different," said Robert Laurens, the lead partner for Accenture's North America utilities strategy unit. Past merger cycles were characterized by much higher premiums (the amount over a company's stock price that a buyer offers in a takeover), which did not really make sense. Those high premiums, Laurens said, drove up the acquiring company's debt-to-equity ratio and required serious cost cutting after the fact to make the deal work, which led to regulatory backlash with commissioners wondering what, exactly, they and the customers were getting out of the deal.

Robert Hevert, president of Concentric Energy Advisors, echoed this sentiment. Premiums in the late 1990s during the last major utility consolidation cycle were much too high, he said. It got to the point, he continued, where takeovers were being completed with premiums from earlier deals being pancaked into the successor transactions; a setup reminiscent of the residential house-flipping in the mid-2000s, which was driven by the pervasive general assumption that house values would continue climbing, essentially forever.

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"There is a lot more discipline in the process now than there had been," said Hevert. Formerly a managing director at Navigant Consulting, Hevert and four partners formed Concentric in 2002, and he says the company's message to clients has remained the same: Be realistic, both about what your operations are worth and about those of any company you consider buying. That message seems to be heeded, he added.

Similarly, Accenture's Laurens said, "most of the premiums are more reasonable now. We have learned that high-end premiums are not sustainable. Business rationale is driving the mergers, not growth for growth's sake."

The utilities' business-minded approach has, in turn, prompted relatively quick action by the relevant state regulators, which furthers the cycle. For example, the state commission approved PPL Corporation's $7.6 billion purchase of E.ON U.S., the parent company of Kentucky's two major utilities, Louisville Gas & Electric and Kentucky Utilities, in just six months. Similarly, it only took roughly 12 months for FirstEnergy to secure the needed regulatory approvals for its $4.7 billion merger with Allegheny Energy.

Now, said Chris Dietzler, a senior vice president with SAIC, utilities are confident that they will be able to secure timely approval from regulators if they come forward with a deal that makes good business sense. Like the companies they regulate, he added, state commissioners understand that the wave of capital expenditures looming in the not-too-distant future will require changes industry-wide, with consolidation being a key option.

An investment banker echoed Dietzler's characterization of the state commissions. "Regulators seem to be more understanding now," he said.

In turn, this relative regulatory openness to utility M&A has helped maintain investor interest in the deals despite their relatively low premiums, added a second Wall Street executive. Now, he said, investors are fairly confident the deals will get done and their money won't be tied up for years in a combination stuck in regulatory limbo.

Taking Their Own Paths

It may seem like Business 101, but one of the things that most impresses SAIC's Dietzler about the current round of mergers is that they are all different; the me-too frenzy of the past is not there. This, he said, shows that

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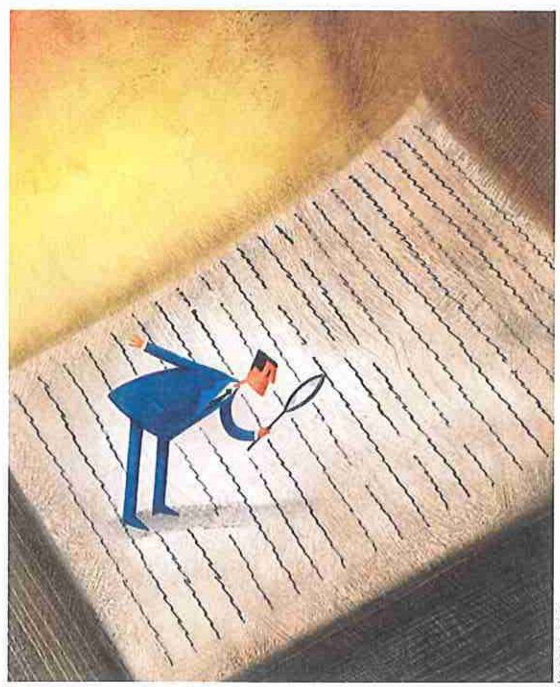

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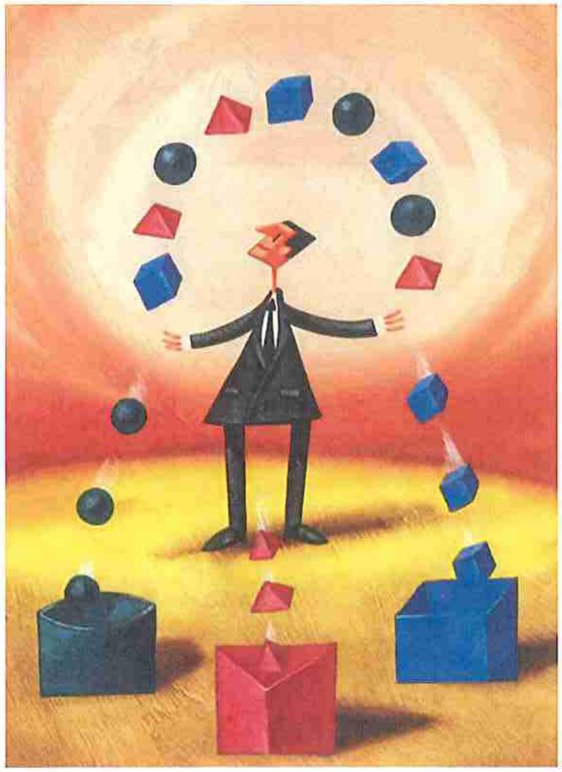
the companies are moving ahead with their own strategies, not someone else's.

While companies all have individual strategies, the mergers can be roughly segmented into three broad categories, said Accenture's Laurens: geographic proximity; acquiring or enhancing skill sets; and portfolio rebalancing. He acknowledged that most mergers would fit into more than one of those categories—"You don't just buy a car for price, it is a combination of things"—but one area usually will be the driver.

For example, while the Duke-Progress merger is clearly a good geographic fit, Laurens believes the overarching rationale for the combination is skill-set-related, particularly as a means of enhancing the generation performance of the combined company, especially on the nuclear side. Similarly, he puts the planned Exelon-Constellation merger in his second merger bucket, pointing out that the $7.9 billion purchase gives Chicago-based Exelon access to Batimore-headquarted Constellation's well-regarded marketing and competitive supply skills. In other words, he said, the company bought skillsets that it needed instead of developing them internally.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A COMPANY MIGHT BUY SKILL SETS THAT IT NEEDS INSTEAD OF DEVELOPING THEM INTERNALLY.

The Exelon-Constellation merger is "a good blend," added Booz's Flaherty. It brings together two companies with different concentrations—Exelon on the generation side and Constellation on the customer end—thereby strengthening both. This point was made in somewhat different language by John Rowe—Exelon's long-time CEO who will retire when the merger closes—at the merger announcement in late April. "These companies fit together beautifully," he said. "We are combining the nation's leading fleet of clean power plants with the nation's leading energy marketing business... in a way that brings value to both sets of investors."

Dave DuCharme, vice president of utility and smart energy services at Capgemini, spoke highly of the proposed merger, pointing out that it indicated a new way of looking at utility assets. Instead of simply trying to combine two companies and wring out cost savings, Rowe and Mayo Shattuck, the Constellation CEO who will become executive chairman of the merged firm, want to capitalize on the individual firms' expertise in a combined operating environment. "This is a fairly new dynamic for the industry," he said.

A Nuclear Note

Progress and Duke have well-regarded nuclear programs—the two companies consistently operate their reactors at annual capacity factors of more than 90 percent. Still, Accenture's Laurens said the additional scale and skills gained from the combination should enable the new company to improve the performance of those and other generation units, both nuclear and fossil.

At the other end of the nuclear spectrum, Laurens continued, it makes no sense for companies to operate single nuclear plants. There already has been a fair amount of consolidation in the nuclear generation sector, but Laurens and other analysts agree there is room for more. The economics "just do not make sense," he said. Companies that operate just one reactor—there are seven such sites in the United States today—must cover the same regulatory, safety, and training costs as the rest of the industry, but are unable to spread those costs over multiple units.

Regarding additional consolidation, he continued, "that shoe has yet to fall. But it will."

While not commenting specifically on the economics of single reactor units, Concentric's Hevert strongly endorsed the idea of fleet operations for nuclear plants as a way of improving performance and cutting costs. "Fleet operations [for nuclear] should be very seriously considered," he said.

More broadly, it is also evident that scale in generation in general—whether it is nuclear, fossil or renewables—makes sense, said Robert Zabors, director of the energy practice at Bridge Strategy Group. This, in turn, is pushing companies to look carefully at their portfolios, with some opting to unload assets no longer viewed as essential while others look to bulk up through acquisitions.

Getting the Proper Portfolio

Although it closed well before the current wave of transactions, Zabors said the three-way deal in 2007 among Great Plains Energy, Black Hills Corporation, and Aquila, could well serve as a template for future deals. Great Plains, the parent of Kansas City Power & Light, paid $1.7 billion to acquire Aquila, the parent of Missouri Public Service, St. Joseph Light & Power, and a number of natural gas utilities spread across the Plains states. Just prior to the closing of that deal, Black Hills bought Aquila's gas utilities, which served customers in Colorado, Kansas, Nebraska, and Iowa, for $940 million in cash.

Essentially, Zabors explained, Great Plains and Black Hills split Aquila, taking the parts that were central to their business plans. Great Plains was able to expand its service territory significantly in the area surrounding the city, adding some 300,000 electric customers to its then-current customer base of about 500,000 and creating what its CEO Michael Chesser termed "an exceptionally strong regional electric utility committed to improving the total living environment for customers and communities by providing low-cost, reliable, clean energy." At the same time, Black Hills was able to build on its existing Colorado operations and move into the three neighboring states of Kansas, Nebraska, and Iowa for the first time.

These types of deals may be more difficult to negotiate up front, Zabors said, but they make great sense in the long term since companies can focus immediately on their core assets. With companies striving ever harder to find the right portfolio of assets, more deals along these lines are certainly possible in the future.

This focus on core operations—what the consultants call portfolio rebalancing or optimization—is also likely to change how executives view current assets going forward.

"There will be some rationalization," one Wall Street executive said. "Why in the world should I be in 11 states."

Along these lines, included in the Duke-Progress merger filing with the North Carolina commission is a note regarding Duke's continued presence in Ohio. The company has said it is weighing its options, including possibly selling its assets there.

PPL's Purchase

Nowhere is this rebalancing approach more apparent than in PPL Corporation's 2010 purchase of LG&E and Kentucky Utilities, which serve about 950,000 electric and 320,000 natural gas customers, and its 2011 takeover of Central Networks in England, whose two regulated distribution units serve some 5 million customers in the Midlands area. Combined with its existing operations in Pennsylvania and elsewhere in England and Wales, PPL will now be supplying regulated utility services to more than 10 million customers.

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IF THE PROSPECTS FOR GROWTH ARE NOT THE SAME AS THEY WERE IN THE PAST, SELLING YOURSELF IS A RATIONAL STRATEGY.

With these purchases, PPL says an estimated 75 percent of its earnings will flow from regulated operations by 2013, essentially the mirror opposite of its actual 2010 numbers, when 73 percent of its earnings came from competitive operations and just 27 percent were from regulated activities.

This is clearly a "material shift," said Accenture's Laurens, but it may soon not seem so unusual. "More and more companies will be thinking about this," he predicted.

Looking Ahead

Predicting the future is always a dicey proposition—run-away commodity prices were a major concern before the recession, and climate change legislation seemed a real possibility in the wake of President Obama's 2008 election, but neither seems like a prominent issue now. However, there is broad consensus that the current consolidation trend will continue. Slow, perhaps, but steady.

There will continue to be takeover offers, to be sure, said Bridge Strategy's Zabors, but another difference in the current environment is that there has been an increase in the number of sellers. Executives across the country increasingly look at their companies and see little room for growth with the sluggish economy. They conclude that the best thing they can do for their shareholders is to put the company on the market. "The prospects for growth are not the same as they were in the recent past," he said.

"Selling yourself is a rational strategy," echoed Laurens.

Another factor likely to continue the consolidation trend is the interest of outside money in the U.S. utility market, analysts said. With U.S. Treasury bonds only yielding around 3 percent, many investors may believe that relatively secure utility investments are a better deal, with significantly higher returns. "If you have dollars, the North American market is a great place to be," said Zabors. There already have been a number of such deals—Macquarie Infrastructure Partner's $3 billion buyout of DQE, Duquesne Light's parent, in 2007 and the 2008 purchase of a 20-percent stake in Oncor, the regulated utility unit of Energy Future Holdings, by Borealis Infrastructure, the investment arm of one of Canada's largest pension funds—and there almost certainly will be more, he said.

The reality is, Zabors concluded: "This is not a single industry anymore." Companies are adopting a strategy and moving forward with it; they aren't simply looking to mimic what their neighbor across the state line is doing.

"The whole landscape has been shifting," added a Wall Street executive.

What that landscape will look like when consolidation finally peaks is anybody's guess. ◆