



# Europe's changing energy landscape

By Gill Rider

As Europe's power industries converge into a single, highly competitive energy market, innovative companies that move quickly will secure the high ground. This dramatic industry restructuring will affect not only local players but also any energy company—from US utilities to oil multinationals—intent on growing its global portfolio.

**T**he race is on for supremacy in Europe's power markets. It began officially in February 1999 with the European Energy Directive, which mandates full competition in the energy sector in all European Union member states by 2008. As the race heats up, contestants will find themselves participating in the most competitive and fastest-moving energy market in the world.

The outcome, however, will have less to do with a legislative timetable than with commercial and market forces—including consolidation, cross-industry convergence, globalization and technological change—which will have greater impact over a wider territory and will move more quickly than the political process. In reality, the liberalization of this sector, already under way, will drive the competitive agenda, accelerating the pace of change and creating a single European energy market.

If ever there were a time and a place for an entrepreneur to be entering the utilities market, the time is now and the place is Europe. The new industry structure that is emerging will provide openings for new entrants and considerable scope for companies prepared to take a leadership position to determine the rules by which the market will operate. Increased competition will require companies to develop new skills to survive, but will also provide opportunities for innovation in both the supply and trading of energy. Companies that take the high ground will be taking on more risk than those that follow, but if they succeed, they will gain a potentially unassailable head start.

To be sure, national differences will persist in the near term. Important variations in regulation and corporate governance across the EU will affect the openness of each country's local power industry to foreign investment, merger or takeover.

However, the single European energy market will be a reality more rapidly than many predict.

## **New models**

These days, it seems you cannot open a newspaper without seeing the announcement of yet another merger, acquisition or alliance in the European utilities sector. Such deals reached record levels in 1998—and, for the first time, European companies outpaced their US counterparts in cross-border merger and acquisition activity in this industry. The size and number of these deals are symptomatic not only of these new competitive dynamics but also of changes so fundamental that the companies operating in the sector today will be unrecognizable in 10 years.

The old model of the vertically integrated utility is breaking up. Common issues across industry value chains will become more important than maintaining the integrity of

that value chain within a single business, creating opportunities for current players and new entrants alike.

At the consumer level, utilities are forming alliances with financial services companies and retailers to manage customer relationships and create innovative customer-service bundles that combine power supply with other products, such as household insurance and mortgages. Similarly, with oil at its current price level, oil companies may wish to create energy portfolios across fuel sources and leverage their relatively sophisticated skills in trading and asset management into energy. For example, companies like Shell, Total, Amoco and Repsol are entering the downstream gas- and electricity-generation markets. These new entrants are well aware of the overlapping value chains and the opportunities available to them, given their superior capabilities and experience in key areas.

The end result will be a market that is unified horizontally, but one that will operate in three quite distinct sectors: *energy*, *asset* and *retail*, each of which will come to have its own distinctive structure. All three sectors will require both a different subset of the traditional energy utility's skill set as well as a substantial infusion of competencies from other industries.

The energy sector will concentrate on the generation of power. The important issues here will focus on the control and management of a portfolio of fuel sources at the top of the energy value chain. Scale will be important, which means this sector will be dominated by a handful of global players.

Control of pipelines and grids will fall to the asset sector, and the key skills required will be asset manage-

ment, risk management and the ability to operate within the various regulatory frameworks. Multi-utility deals and cross-border pipeline projects will quickly move this sector beyond its original national and industry boundaries.

Finally, at the retail level, there will be a growing exploitation and segmentation of existing energy customer bases and a diversification of product areas. These groupings will probably emerge at the regional level.

#### **Shopping for energy**

As markets open up and new players enter, prices and margins will be forced down. In the Nordic countries, for example, where the industry was deregulated ahead of the European Energy Directive, power is already 20 percent cheaper than before liberalization. Monetary union will make price differentials between countries more apparent and harder to sustain in the face of consumer pressure—pressure to which the most dedicated nationalist and protectionist governments will have to yield.

Consumers will therefore begin to see extensive cross-industry convergence at the level of retail supply. Already, energy companies are offering credit cards, and retailers are offering energy discounts as part of their customer loyalty schemes. These groupings will proliferate as the pressure to retain and acquire customers intensifies. Initially, churn in energy markets was low because users waited for their existing suppliers to react to price or service competition. Shopping around for energy will become increasingly common. In the United States, energy companies already are buying real estate firms to ensure they get the first shot at home buyers.

It will be difficult for an existing utility to prosper on all three levels; companies simply do not have the required skills to compete in some areas. So there is a potential both for alliances with or aggressive entry by outsiders who possess those skills. For example, a former utility monopoly would have little experience with brand management, and might therefore prefer to partner with an established consumer retailer rather than build the skills. Just as easily, of course, an established retailer could use its own branding and customer-management skills to target the utility's customer base.

Intense merger, acquisition and alliance activity will continue for some time yet. This will inevitably increase in scale and scope, shifting from opportunistic tactical moves to more coherent and strategic pan-European initiatives. The new power blocs that emerge might be regional groupings—for example, the Nordic power bloc is already a reality—or they might be pan-European in scale. There will also be room for smaller players to thrive at a local or market niche level. Others will establish specialist capabilities. The United Kingdom's Eastern Group has set up three key trading joint ventures in the Netherlands, Sweden and Spain.

Non-European players will undoubtedly plunge in, as they have in the UK electricity industry; however, they may not find the road to acquisition quite so smooth in many EU states. Besides, there are opportunities for expansion in Europe other than acquisition. US-based Enron entered the German and Dutch electricity-supply markets by cherry-picking large industrial clients from under the noses of the incumbent domestic utilities. Dutch company Gasunie lost some of its industrial customers when they were approached

by a joint venture between US power producer AES and Dutch distributors PNEM-Mega and Delta, which supply gas piped from North Sea fields via new infrastructure links.

**Gas is king**

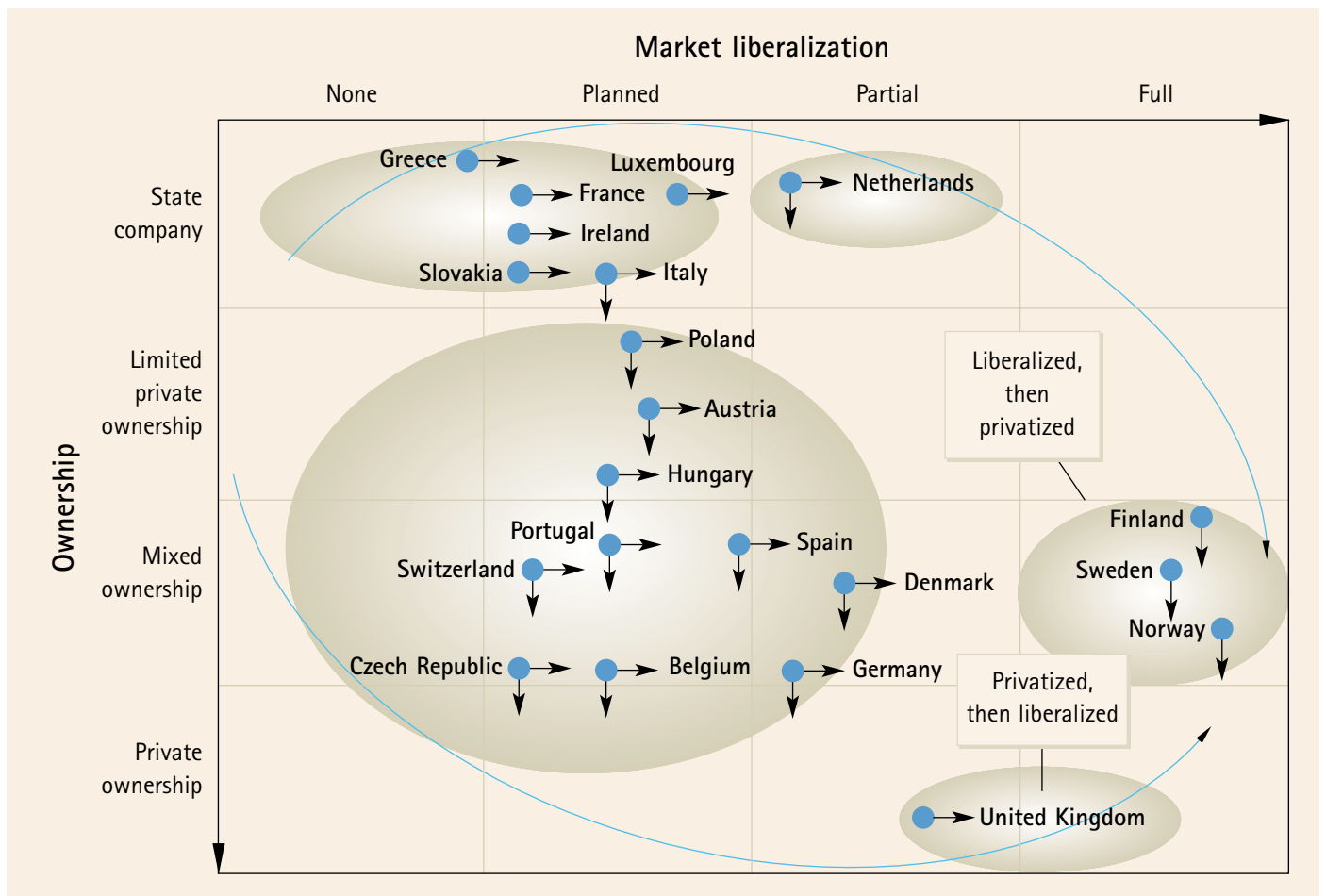
Historically, countries across Europe have relied on different energy sources—oil, gas, coal, water, nuclear—depending on cost, natural resources, politics and other variables. In the near future, a single European energy network will emerge, with gas as the dominant fuel. Several factors are driving the demand for gas, including new technologies, new sources of supply, demands for price reduction and

environmental concerns. Gas is cheap, accessible, flexible and clean, and 70 percent of the world’s natural gas resources are in the EU’s backyard, chiefly in Russia and North Africa. Analysts estimate that more than half the power plants commissioned in the EU during the next decade will be gas-fired. Together with the conversion of existing oil or coal plants, this could mean that gas will account for around 50 percent of all the power generated in the region by the year 2020, compared to a mere 7.5 percent in 1992.

This single change will blur the boundaries between the electricity and gas industries and will remove the

**Power play**

National energy markets in Europe are at different stages of privatization and liberalization. But most are expected to converge into the deregulated/privatized space.





## Risk management could be the most important survival skill in this brave new world of European energy.

existing bottlenecks associated with electricity transmission. Users will be able to treat electricity and gas interchangeably as power sources.

With the move to gas, smaller and more efficient localized cogeneration power plants, based near users, will replace traditional remote power stations based near fossil fuel sources. Bord Gáis in Ireland recently requested authorization to construct 150 such small plants. Gas can adapt to the demands of the biggest customers. Large industrial users will partner with energy companies and invest in their own power plants, primarily for heat generation—selling the surplus electricity back to the grid, making the meter run backward.

### **Power trades**

As both national and industry boundaries become less relevant in this sector, cross-border trading of power will become more common and have a greater effect on profitability. Succeeding in an industry that combines a physical utility market (generating and supplying electricity and gas) and a financial market (where fuels are treated as basic commodities, such as corn or coffee) will require a huge leap in skills for most European utility companies.

The sheer complexity of this market—a commodity product as volatile as electricity, traded across 15 countries, in entirely different market and political conditions—presents an exceptional challenge to the industry.

This is underscored by the fact that electricity prices are underpinned by a wealth of variables: mix of fuels, oil and gas prices, regulatory developments, supply and demand, weather conditions and so on.

Traders already are hedging against volatility in spot prices with the emergence of a futures market in electricity. Twenty percent of electricity demand on Nordpool, the Nordic power exchange, is now traded through futures. However, the risks should not be underestimated. In Sweden, at least five utility brokers have gone bankrupt for failing to understand the complexities of trading.

Indeed, risk management could be the most important survival skill in this brave new world of European energy. New risks—financial, regulatory, political—are emerging all the time. Costly transmission infrastructure projects may be threatened by the trend toward local generation. Regulatory frameworks alter access to key markets, while end-user prices may become highly volatile. Changes in government could usher in new policies toward preferred fuels.

Industry analysts have predicted that a mere handful of companies will dominate the global utilities industry in the future. Although this is likely for the energy sector (the generation of power), both the asset sector (pipelines and grids) and the retail sector will support greater numbers of operators. The basis for competition differs considerably across each of the three sectors because the optimum scale of operation is not the same. More important than the number is the type of company that will emerge.

The wide array of options means that there are no simple or obvious choices

for players in this market, no obvious route to follow. There are, in fact, a number of plausible permutations:

- Nationally focused niche player.
- Large, vertically integrated company operating in several markets.
- Asset-free market maker, trading on Europe's new Energy Exchange.
- Something entirely different.

Even a decision to wait and see does very little to narrow the variety of options. All players must sooner or later make a number of critical choices—whom to ally with or acquire; whether to operate at a local, regional or pan-European level; and in which sector of the market to specialize. None of these will be obvious or inescapable choices, and much will depend on a careful analysis of each company's current position and resources, as well as its ability to access and integrate new skills.

Corporate governance in Europe's emerging energy market will therefore become more crucial to success, more complex and infinitely more stressful to carry out. The three sectors that emerge from the old utilities structure will each require radically different management approaches and strategies.

From the simplest ownership structure imaginable, former monopolies will now find themselves involved in complex portfolio arrangements of ownership, partnership and cross-shareholding. Merger and (often hostile) acquisition activity will proceed at a furious pace, requiring executives to be both vigilant and quick to react. Alliances will operate both up and down the supply chain and across industries and borders, and

will require careful management of relationships with entities from different professional and cultural backgrounds. At the same time, evolving stakeholder groupings, regulatory structures and investment communities will subject these new arrangements to ever-closer scrutiny.

Clearly, there has never been a more challenging or exciting period for executive management in the utilities industry. ■

*This article is based on an Accenture study, "European utility landscape."*



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