

30 Years of Consolidation

Are the Benefits Real?

By Tom Flaherty and Todd Jirovec, Strategy&



The current era of utility sector consolidation has now extended through three consecutive decades of sustained activity. Since the late 1980s, power and gas companies have been in a near continuous state of combination or rationalization with industry partners or financial sponsors.

Even with this substantial consolidation among industry participants, the utilities sector has achieved far less concentration than other sectors like airlines, telecommunications, health care, or commercial banking.

In today's environment, utilities' merger and acquisition interest remain high, capital costs are still low, regulatory orders acceptable, and actual post-close integration has created sustained benefits. Strategic, financial, operating, customer, and cost areas have each been positively affected through consolidation.

However, many observers are still skeptical about where and how these benefits from consolidation have been derived. Understanding the impacts from prior transactions may tell us a lot about what the industry has actually accomplished and can continue to attain.

Transaction Cycles

Today's power and gas utilities sector is the product of steady consolidation occurring in a series of natural cycles. These cycles existed between 1989 and 1994; 1995 and 2000; 2001 and 2010; and 2011 through today.

These cycles reflect different competitive eras for the utilities industry as sector restructuring (unbundling), regulatory shifts (return levels) or catalytic events (financial markets) created need or opportunity for action.

Over these cycles, the total number of transactions previously pursued or completed since 1989 exceeds the actual number of remaining companies in the electric and gas sectors. From more than a hundred and fifty tradable electric and gas companies, the utilities industry has shrunk to fifty tradable entities.

See Figure One.

The first cycle was comprised of opportunistic first moves that preceded the eventual shift in industry restructuring. The first transaction of this cycle, the Kansas Power & Light and Kansas Gas and Electric transaction in 1990, is often recognized as jump-starting the ensuing groundswell of new era consolidation.

This transaction, itself an outgrowth of a hostile attempt by Kansas City Power & Light to take over Kansas Gas and Electric, parlayed surprise into opportunity and proximity into value. Deal close then precipitated sporadic industry consolidation for the next six years.

The second cycle – the first true wave of transactions – was distinguished by two peaks of transaction announcements in 1995 and 1999 not seen again since this period. These transactions were catalyzed by the specter of industry unbundling and open wholesale and retail competition. Consequently, scale and customers were

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highly sought, forming the logic for many combinations.

The next cycle, lasting from 2001 through 2010, created a long series of transactions across two major market downturns. This consolidation phase reflected a retreat from competitive businesses and a refocusing on core utility operations and building value from economies of scale.

The final cycle began in 2011 as the economy began to recover. It also occurred as the climate change debate began to gather momentum. Coal-based utilities were concerned that a portion of their generating assets might not be available in the future and their financial prospects could be at risk.

We are still in the midst of this current cycle today, though not for the same reasons. This phase is characterized by a growing recognition that the difference between the largest and smallest companies is widening and remaining as a competitive stand-alone entity may not be viable for the long-term without increased financial scale and strength.

Getting at Value

Utility managements closely watch their peers and learn from each other's actions. Perhaps the most essential benefit unlocked through these prior transactions, other than economic results, was dissolving the insularity existing within the utilities industry.

For transactions occurring through this thirty-year cycle, utilities merged under the premise that synergies would provide sufficient justification for a transaction. But over time, companies began to think of benefits more broadly than just added customers, cost economies and lower rates.

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FIG. 1 THE SHRINKING U.S. UTILITIES SECTION

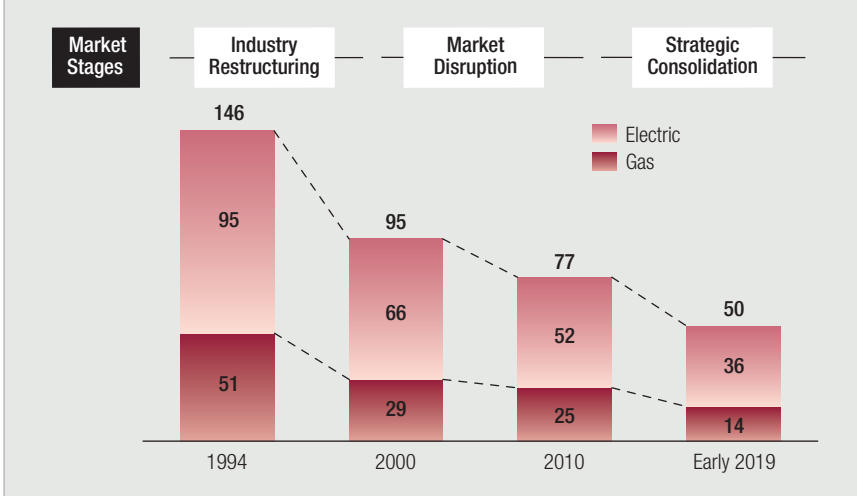
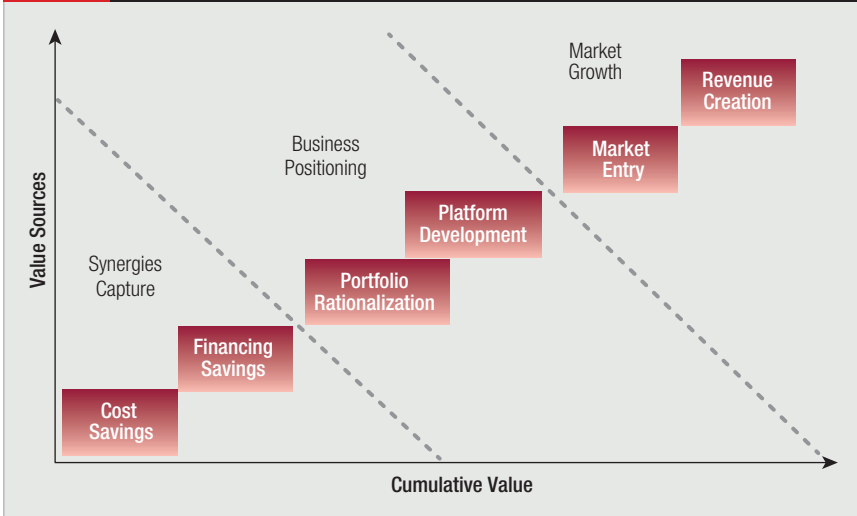


FIG. 2 SOURCES OF DEAL VALUE



Benefits were sought from balance sheet strength and improved cash flow. System and asset performance improvement were also viewed as critical outcomes in the market and to customers. And new growth and revenue sources became important dimensions of post-close company positioning.

See Figure Two.

In early consolidation cycles, attainment of synergies was often the rationale for the transaction and the barometer for success. Driving duplicative costs out of the business was a goal of most managements during these timeframes with combinations viewed as an easier way to achieve results than intrusive and exhausting stand-alone programs.

The industry performed admirably in attaining the results expected from transactions. Operating models evolved, organizations integrated, back-offices aligned, processes streamlined, and costs decreased.

For large combining companies, hundreds of millions of dollars of costs could be reduced annually. Even small companies

that combined could see tens of millions of dollars in annual costs reduced.

Companies proved to themselves, and to regulators, investors, analysts, and customers, that they had the ability to successfully design and execute an integration process and realize cost synergies. They also demonstrated to themselves that they could use a merger or acquisition to strengthen their position in the market.

Transactions have evolved beyond their targeted focus on cost reduction from overlap, duplication, and economies of scale. Companies are now interested in how to use the combination as a means to extend their growth agenda. They are expanding the focus of a transaction from simple cost shrinkage to more difficult revenue expansion.

A different perspective is now considered when assessing the potential benefits from combination. Managements have begun to talk about line of business entry, alternative technology deployment, new capabilities development, and product and service introduction.

Utilities are recognizing consolidation can be both a catalyst for faster growth and a platform for enhanced business positioning. Top-line expansion is now paramount.

Consolidation Evolution

Consolidation success by utilities naturally spawned interest from other types of buyers. These non-traditional buyers further shaped the consolidation landscape as they brought their own view of how benefits could be created through consolidation.

First it was foreign utilities believing that their earlier country restructuring programs gave them superior execution capability compared to their U.S. counterparts.

Then private equity entered and hypothesized that leverage and a clearer view of investment and performance could yield financial benefits to an owner.

This buyer group was followed by infrastructure funds that recognized that utilities could yield attractive returns as a long-term hold while still acting as responsible stewards.

While these classes of buyers each had differing views on how benefits could be derived through acquisitions, two constants emerged: financial benefits related to integrity and flexibility metrics

were highly valued, and cost and customer rate level reduction or constraint were acknowledged as the price of admission to enable financial benefit capture.

The history of transactions and buyers has clearly evolved management thinking about the merits of consolidation. Leadership teams now recognize that consolidation can be a strategy, not just a consequence.

Initial utility transactions largely reflected changes in market drivers that were often unpredictable or uncontrollable by incumbents. These combinations usually just resulted in eliminating more stand-alone utilities from the landscape.

Over the last twenty years, the sheer size and concentration of the sector has significantly increased as fewer utilities remain. Sector market value has grown over two hundred percent to over \$750 billion, roughly twice the growth of the S&P 500 market capitalization over the same period

See Figure Three.

The largest ten utilities, the vast majority of whom have engaged in prior transaction activity, account for over half of this market value as compared to approximately three percent for the smallest ten utilities. This is a significant increase in concentration compared to prior decades.

See Figure Four.

Even with this amount of consolidation, utility sector concentration still trails other industries.

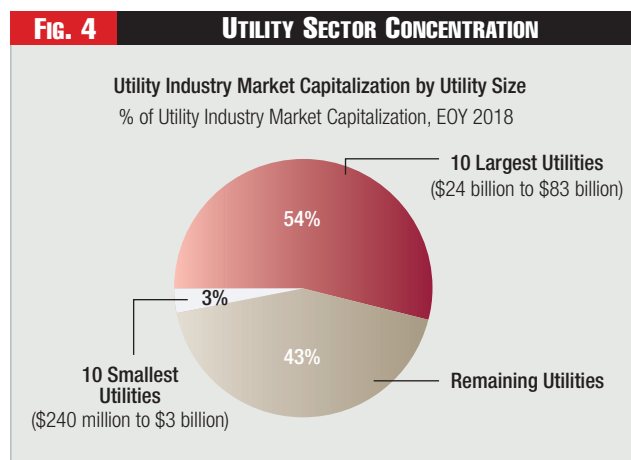
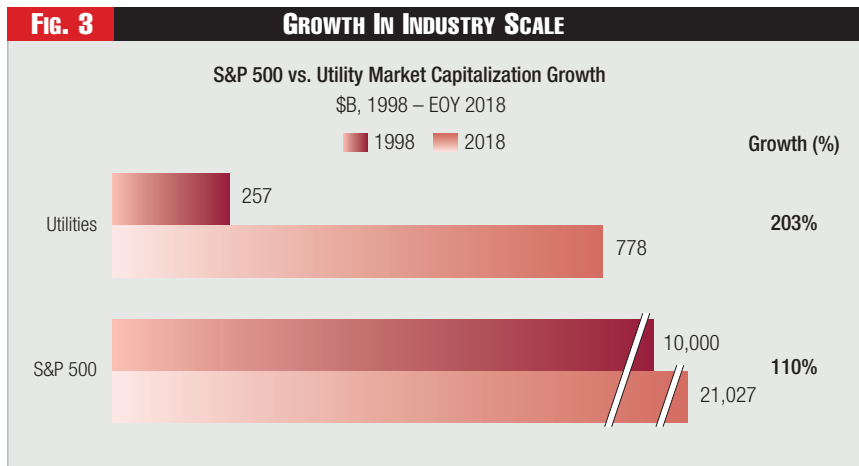
The objectives of transactions are also shifting and evolving from increasing the scale of the business to rationalizing the scope of the business. Companies have increased their willingness to consider what assets or businesses may not fit the future business.

Portfolio rationalization, such as optimizing the future contours of the business, is leading to new transaction options. Earlier consolidation is now spawning a second wave of divestments that create buying opportunities.

These rationalizations have occurred for small operating companies within a larger portfolio, dispersed properties outside the primary footprint or assets that no longer fit the strategic objectives of the current owner.

Over the last several years existing owners have conducted targeted sales of businesses or assets (usually through broad auctions) that they believe to be more valuable to a different owner. Financial sponsors have also been willing to dispose of earlier investments and harvest value created over their hold period.

These secondary divestments allow the owner to sharpen its portfolio focus, as well as to open the market to entities



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that may be too small to transact on a larger scale or too risk averse to undertake a major change to its business from outright combination.

These second, or third, owners create a deeper buyer pool for future dispositions and expand the options to current owners

in an industry seeking sustained growth.

Traditional regulated business consolidation is also complemented by merger and acquisition activity in adjacent business sectors. As the technology revolution accelerates and gains traction, utilities are searching for additional growth vehicles.

Several companies have expanded their strategic horizons to include finding non-regulated businesses to acquire. These transactions are designed to both secure new capabilities in areas believed to be important to future competitiveness or to acquire an existing book of business that could take years to build.

With the number of potential candidates available in the energy management, software development and solutions delivery

sectors, utilities focused on growing their energy services businesses have ample choices at affordable values.

This continuing evolution of consolidation in another form presumes that realization of benefits will continue, though potentially from non-traditional sources or through unique channels.

Stakeholder Benefits

Whether a utility transaction allows a buyer to create value has been continuously debated through the years. And analysts and regulators have frequently asked whether the outcomes produced have been worth the price paid.

These groups particularly challenge whether the success of utility mergers and acquisitions has been taken as an article of faith or is simply fool's gold. Other third-parties wonder whether these benefits even truly exist and how they can be factually demonstrated.

benefits through a purely shareholder value creation lens in this sector is difficult.

First, the market structure of the industry includes regulated and nonregulated portfolios with different growth paths and underlying businesses, creating different shareholder ownership attitudes and affecting valuations at any point in time.

Second, the time lag to closing transactions can widely differ and unrelated management decisions or market events, such as business shifts, rate cases, operating disruptions, etc., can create non-merger impacts affecting individual valuations.

Third, benefits sharing constructs between shareholders and customers make post-close transaction financial outcomes hard to discretely distinguish as approval elements such as savings retention, rate moratoriums, etc., can be hard to compare to pre-close values and ultimate outcomes may not be known for several years.

Finally, multiple externalities and changes in business conditions impact both sector and individual company valuations and, as time advances post-close, make it difficult to measure pure merger impacts relative to cyclical shifts.

This is not to suggest that transactions do not yield positive benefits for shareholders. Review of TSR results for acquirors and non-acquirors over the twenty years ending in 2017 simply does not yield consistently dispositive data across multiple years.

Year 1 after a transaction reflects the write-off of transaction and integration costs and distorts comparability across near-term time periods. However, steady-state value from synergies emerges in year two and extends for several

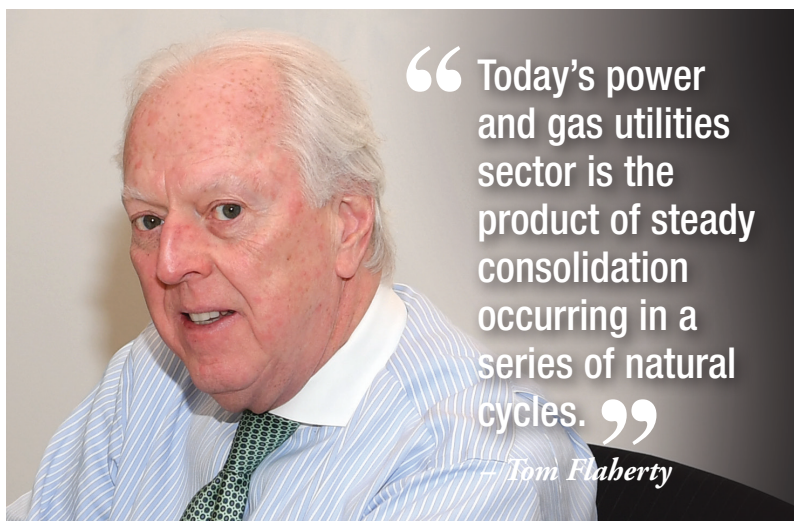
years, typically indicating positive differentiation in TSR as compared to non-acquirors.

However, once other external events begin to occur – market or regulatory – these events begin to dissipate positive transaction impacts.

Exogenous factors, such as environmental mandates, stock market volatility or, economic trends all can adversely affect the earnings profile of the utility sector or a utility and decouple transaction results from cross-sector comparison. Consequently, pure, long-term financial results are difficult to use as a barometer of transaction success.

However, other sources of data exist that can illustrate the benefits from transactions to the sector, its companies and its customers, that have been gained from consolidation over the last three decades. These comparisons suggest that acquiring utilities have fared better than their non-acquiring peers across multiple dimensions.

To explore whether differences in performance between



“ Today’s power and gas utilities sector is the product of steady consolidation occurring in a series of natural cycles. ”

— Tom Flaberty

Not surprisingly, our review of these questions suggests consolidation benefits have been created across multiple areas, with different types of demonstration empirics.

Intuitively, we know benefits are realized or transactions would not be pursued and serial acquirors would not continue to participate in consolidation. And while some areas of benefits realization are discrete and measurable, others are harder to discern and demonstrate.

Several attributes can illustrate whether real benefits have resulted for stakeholders, such as shareholders, customers, regulators and, the broader public from utility consolidation. But while multiple angles of assessment exist, consistent and uncontroverted comparable data is not always available, which is why it is seldom undertaken, and lingering questions remain.

Analysts typically like to start with the financial impact to shareholders from transactions, i.e., some form of overall value test like total shareholder return (TSR) or relative market value added (MVA). However, the ability to measure

acquirors and non-acquirors could be discerned, the remaining industry tradable entities were segmented between acquiring utilities and non-acquiring utilities. Twenty-six were deemed acquiring utilities, i.e., completing a strategic transaction, while the remaining were not.

Acquiring utilities have increased cash flow at an increased rate compared to their non-acquiring peers. On balance, acquiring utilities have increased cash flow at a compound annual growth rate over forty-five percent higher than non-acquiring peers over the last twenty years.

See Figure Five.

Those companies having successfully conducted transactions should see higher cash flow, in part, given their abilities to capture synergies – whether reduced or avoided costs – from consolidation. And this cash flow can be redeployed rapidly into the infrastructure as the historical level of capital investment has shown.

These cash flow levels have both supported the modernization of the grid to enable better resiliency plus the ongoing transition to more efficient and cleaner generation technologies.

New revenue growth demonstration is less transparent, however, the strategic rationale for many transactions is predicated on assimilating complementary components of the value chain that can lead to higher margins or revenues in the future.

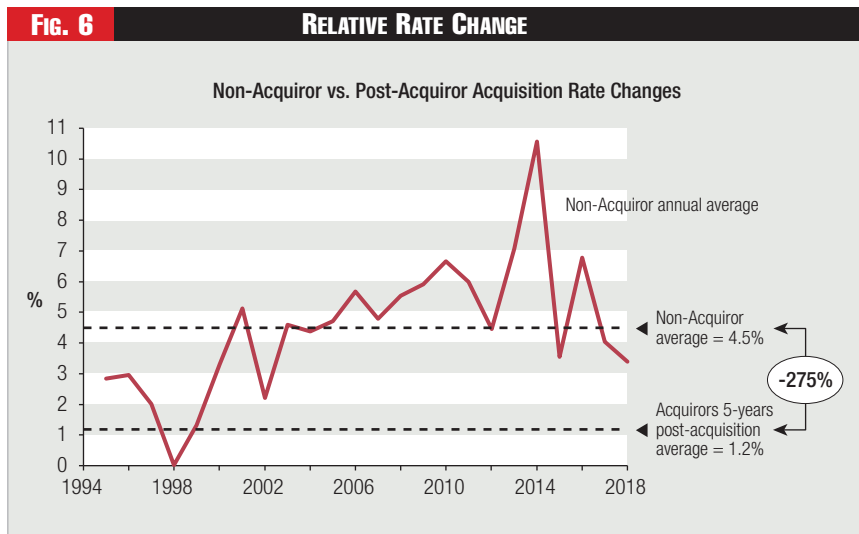
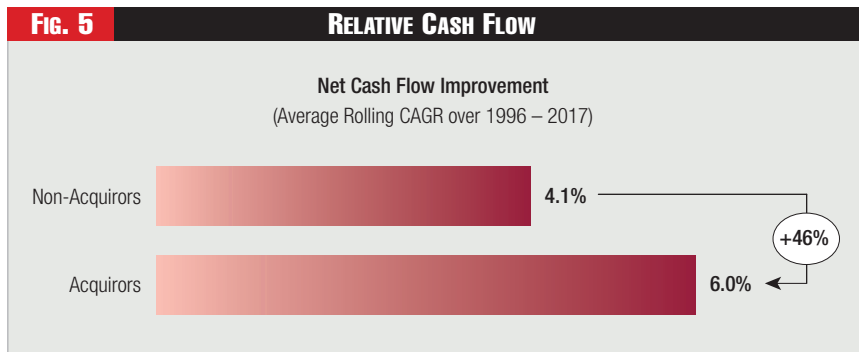
For example, utilities with gas-fired generation have acquired gas midstream companies to provide security of gas supply to customers through pipeline access or new investment opportunities to extend the infrastructure to needed areas.

Several of the larger companies completing transactions in the last several years are specifically targeting new pipeline investment through co-ownership with other partners to take advantage of market opportunities.

Despite this high level of continuing capital investment, acquiring utilities have filed total lower rate requests than non-acquiring utilities. Utilities engaging in acquisitions have an almost three times lower average rate request in the five years subsequent to a transaction as compared to non-acquiring utilities over the last twenty years.

See Figure Six.

The difference in rate request levels does not solely arise from having successfully completed prior transactions but indicates that



acquiring companies are able to forestall and/or reduce planned rate increases through higher cash flows arising, in part, from synergies beyond what their peers are capable of accomplishing.

Utility customers have also experienced rate growth far less than inherent in the broader economy. Electricity rate growth consistently lags inflation growth. From 2008 to 2018, the CPI increased 16.6 percent over those ten years, while electric rates increased 10.5 percent.

Time-to-value for utilities from a transaction has also steadily decreased. Most regulators have precedents from previous mergers in application of their specific state merger standards. The average time to secure regulatory approvals decreased from over fourteen months in the late 1990s/early 2000s to around nine months over the last three years.

Serial acquirors have become particularly strategic in the creation and positioning of their regulatory approval plans with state commissions and adept in fashioning responsive beneficial outcomes to stakeholders. The conditions and commitments within merger approval filings have been effective in advancing customer interests.

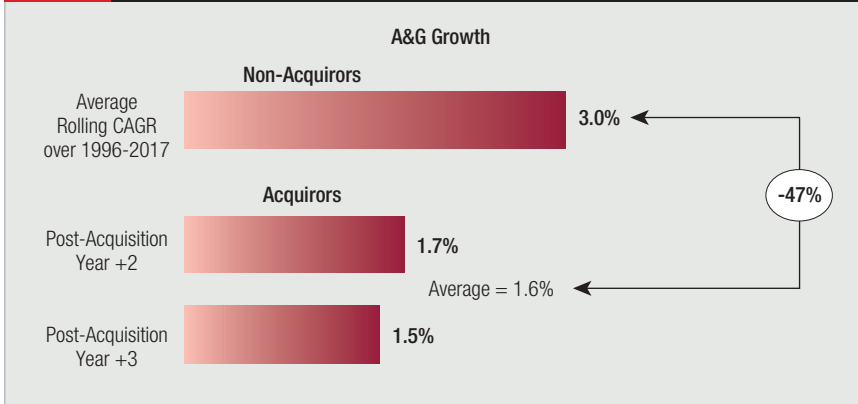
Operating Costs

Merger costs savings have been a key driver of transactions in terms of earnings accretion and demonstrating positive

FIG. 7

RELATIVE COST IMPACTS

Source: FERC from its Strategic Analysis



customer benefits. The industry has focused on cost containment in response to the headwinds inherent in cost structure and used transactions as a means to a lower cost base.

Specifically, wages, benefits, mandates, taxes, and general escalation all contribute to a rising cost environment unless actively managed. While not the sole focus, transactions compel a broad and rigorous integration process to capture costs related to overlap and duplication, and available from economies of scale.

Ongoing consolidation has instilled a stronger cost management discipline within the sector. Lower operating costs are not entirely attributable to transactions, but acquisitions have significant impacts to both cost baselines and cost growth. If companies cannot manage costs effectively, an acquirer will gladly do it for them.

FERC data was evaluated to understand how the industry’s cost structure has changed during the last two decades. Individual company operating and maintenance costs were adjusted for less controllable expenses, such as transmission wheeling, pension costs, uncollectibles, etc.

When aggregated at the sector level, operating and maintenance costs per customer have declined from an average of \$377 for the five years ending 1999 to an average of \$372 for the five years ending 2017.

When translated to real costs over this time period, the decline is even more pronounced; 1999 inflation adjusted operating and maintenance costs per customer are \$561 compared to \$381 for the year ending 2017.

Multiple sources of merger savings have been captured that would not be available ‘but for’ the deal. Thus, utilities are able to use transactions as a catalyst to move toward the performance frontier.

As the nature of transactions has evolved, so has the pursuit and realization of synergies. Synergies estimation over this period has become consequential, without being overly aggressive. But investors and regulators alike are pushing utilities to be more purposeful in identifying and measuring benefits resulting from combination.

throughout the full organization.

FERC data segmentation between acquiring and non-acquiring utilities was utilized to assess whether corporate center synergies have been attained. Administrative and general (A&G) costs

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were reviewed and include the functional costs where overlap and duplication most directly exist between combining utilities.

Acquiring utilities’ A&G costs grew on average less than half as much (1.5 percent - 1.7 percent depending on the year) as compared to non-acquiring utilities (3 percent). While other factors would affect this comparison, it illustrates what is expected – the areas most affected by a transaction tend to illustrate lower growth than a stand-alone utility.

The assessment period included the second and third year after a transaction closed to account for the time necessary to fully integrate these functions and achieve steady-state. Functional consolidation is limited in the first year after close as integration is just beginning, making a comparison of first year post-merger costs changes less useful.

See Figure Seven.

While overall cost reduction has been achieved as a result of transactions, regulators have played their part in ensuring customers realize these savings in tangible ways.

Regulatory plans approved by state commissions result in permanent rate reductions, one-time bill credits, and/or stay-out periods for filing a future rate case. Complementing these tangible benefits are often commitments to enhance service levels to customers.

Transactions have also benefited a larger set of stakeholders beyond customers. Merger commitments have included funding contributed to economic development programs, headquarters expansion/retention, local community contributions, workforce training, and infrastructure investment.

Prior transactions have resulted in lower costs and meaningful benefits to customers and other stakeholders. Incremental or accelerated investments, commitments and related tangible benefits are the direct result of consolidation within the industry.

Shareholders have also benefitted from improved financial strength and liquidity, particularly in how future capital deployment is targeted. They are also benefitting from the increased focus of management on strategic positioning.

While direct measures like TSR are affected by market, regulatory, and other exogenous factors that reflect investor sentiment, cash flows for acquirors have increased at a greater rate than for non-acquirors and support continued capital investment.

These foundational elements of the availability and realization of merger savings will continue to provide the basis for future consolidation.

Looking Forward

Nothing on the horizon suggests that the consolidation wave in the utility industry is close to cresting, even with a shrinking industry. Companies still have appetites for growth and shareholders still expect managements to expand their business and earnings.

Accomplishment of benefits like those described and illustrated above are real and should buttress the belief that value is created through consolidation to shareholders and customers alike.

With thirty-six transactable electric utilities and fourteen transactable gas utilities in the United States, continued consolidation still has room to continue. Fewer transactions may occur annually, but with approximately thirty-five percent of the electric sector and all but three of the gas sector with equity valuations less than five billion dollars, shrinkage is inevitable.

Managements have largely exhibited discretion and restraint when considering potential transactions with no reason to expect this to end. Consolidation has proven to create value across many measures and there is no reason to believe this will dissipate.

Financial discipline has been at the core of utility transactions through the prior periods of consolidation and is a cornerstone

of company strategy – shareholders expect it and regulators demand it.

In the future, we can expect the nature of transactions, and hence value creation, to evolve even further from what has occurred to-date.

The Big Become Bigger: large companies have both the appetite and the capability to grow. Companies at the top of the industry know that scale is an advantage that can be captured to enable a robust growth agenda. Expect several of these largest companies to set a higher bar through break-out transactions.

Transaction Scopes Become Broader: electric and gas companies have already stepped outside the utility space and into midstream investment, acquisition and development. And

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several companies are investors or owners of ‘new energy’ businesses focused on energy services. Expect exploitation of adjacencies to grow in number and scale.

Rationalization Becomes a Norm: managements understand that not all assets or properties make sense to hold indefinitely and that higher value may be captured by another owner. Expect continued transfer of discrete holdings that do not enhance value to an incumbent and can simplify their business.

Value Sources Become More Diverse: merger synergies are fundamental in consolidation to compensate for the strategic, financial and regulatory risk assumed. Expect future combinations or acquisitions to complement a cost focus with more revenue, investment, financing, and capabilities contribution to value.

After three decades of consolidation and attendant accomplishment of original transaction objectives, managements that acquire or merge will pursue this growth path as long as benefits realization continue or until externalities intrude on value capture.

Armed with this history of benefits creation, a fourth decade of consolidation seems likely to continue unabated. **PUF**

According to the U.S. Labor Department – its Bureau of Labor Statistics – electricity prices paid by the average American consumer were the same in February of this year as they were in February 2018. No change over the twelve months. Zilch. Nada.

Yet, prices paid by the average American consumer for all the goods and services he or she buys increased one and a half percent during those twelve months. What does this difference mean between the change of zero for electricity and one and a half percent for all goods and services? Well, it means that electricity prices are decreasing inflation-adjusted. Consumers may complain about how the prices of everything from health care to higher education is rising. But if they say that about electricity, they might check the numbers.