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Tackling the Tough Times
*Utilities' Path from
Financial Stress
to Strategic Success*



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EXECUTIVE SUMMARY

Industry structure is fundamentally reshaped by discontinuity. As the economic crisis drives massive government intervention and market disruption, time will tell whether utilities will simply subsist or rally to thrive.

Utilities are learning many painful lessons during the market downturn. One of the most crucial lessons, perhaps, is that constant vigilance over liquidity position and balance sheet strength is not just a response to difficult times; it is a critical strategy even when the economic outlook is strong. Unfortunately, companies are now learning this lesson the hard way, scrambling to build cash reserves while looking wistfully upon

acquisition bargains unlikely to recur. During this time of upheaval and unpredictability, smart management teams will recognize that reduction and retrenchment are not their only options. Rather, utilities have the opportunity to revamp their business models, rationalize operations across their businesses, and seek growth opportunities while competitors are distracted.

WEATHERING THE STORM

Though faring better than their industrial counterparts, high-dividend-paying regulated utilities have not been immune to the fierce equity price erosion of the past few months. As of October 31, 2008, the Dow Jones Utility Average has declined 31 percent from its 2008 peak on January 9. The most precipitous declines have occurred in the merchant generation and retail company sector, with stock prices down approximately 50 percent to 80 percent relative to their 2008 highs, challenging once again the sustainability of this business model.

Not surprisingly, commodity prices have also declined, with spot oil, natural gas, coal, and uranium prices dropping between 40 percent and 50 percent relative to their 2008 highs. The liquidity crisis has thus forced utilities to replace credit at much more expensive levels (when credit is even available), suspend stock repurchase plans, cut back on capital expenditures, pursue new sources of capital, and draw on credit facilities to accumulate cash. All of these steps were necessary to preserve credit ratings and avoid the further deterioration of financial flexibility.

Some fearless and well-heeled companies have already begun to capitalize

on this discontinuity. In September, Warren Buffett-backed MidAmerican Energy agreed to acquire Constellation Energy, an enterprise that as recently as the last trading day in August had a market cap of \$11.9 billion, for \$4.7 billion. In addition, Exelon has offered to buy NRG Energy—which had a market cap of \$8.9 billion on August 29—for \$6.2 billion, and First Reserve has invested \$300 million in preferred stock of Reliant Energy. These examples suggest that even in today's treacherous, liquidity-driven environment, financially strong companies are able to transact when most others are relegated to the sidelines.

Thus, with turmoil comes opportunity. We see utilities already doing the basic blocking and tackling of aggressively managing cost levels, with a focus on constraining operations and maintenance expenses. To capitalize on market disorder, however, thoughtful companies need to give their attention to three additional areas in the short term: rigorous cash flow management, sober portfolio evaluation, and the clever pursuit of opportunities that will position them for long-term success. These time-tested strategies may offer sanctuary to more than a few management teams in this era of “credit climate change.”

LIQUIDITY, LIQUIDITY, LIQUIDITY

While the ratings agencies generally believe that the utilities industry is adequately positioned to meet refinancing requirements, the lack of liquidity that caused the economic tsunami during the late summer and early fall of 2008 suggests that extra prudence may pay off. While some in the industry have already drawn on available lines of credit to solidify their cash positions, there is also a fundamental need for companies to create their own liquidity by enhancing cash-flow generation. Finance organizations need to work closely with businesses' operating units to elevate their attention to working-capital management. Though utility finance organizations continually focus on understanding their cash-on-hand positions, they pay markedly less attention to the components and changes in working capital.

Value—and cash—is often unnecessarily trapped in working capital. With relatively little effort, management can find ways to free up additional sources of liquidity from either current assets or current liabilities. There is no substitute for cash in a capital-intensive operating business, and executives who have experienced formal reorganization proceedings find themselves focused on the relentless preservation and pursuit of cash every day. Most industry executives, however, do not share this appreciation for liquidity management with those who have toiled through the endless challenges of cash conservation and realization. Thus, the current crisis is an opportunity to embed the processes and discipline to aggressively manage liquidity and produce sustainable benefits long after the credit crisis subsides.

While utilities must better mine their available sources of cash, they also need to reassess the use and timing of cash that is to be deployed. Earlier in the year, conversation in the sector focused on the significant investment required to maintain the aging infrastructure, build necessary transmission, migrate to the smart grid, invest in new baseload capacity, and satisfy renewable portfolio standards, among other needs. It was assumed that increases in capital expenditure (CapEx) would naturally continue to outpace depreciation rates, creating upward pressure on rates that regulators would need to support. With the downturn in the economy, this outcome is no longer a sustainable presumption.

Today, one- to three-year CapEx plans are being scaled back (by about 20 percent, on average, though often by more than that) to reflect a slowing economy and constrained access to capital, as well as to avoid exacerbating a regulatory recovery issue. Ratings agencies are also looking for signs that companies are focused on conserving cash and protecting balance sheet flexibility to reduce the pressure on ratings criteria.

Companies are now forced to reassess how much capital they can effectively deploy in the near term and what elements of their plans can be deferred or resized safely. Near-term investment plans thus reflect what companies can prudently afford today, while non-core projects are deferred until the market becomes more stable. CapEx reductions are likely to further increase, which, of course, has other ramifications: Such reductions preserve cash flow in the short term, but at the expense of earnings that are permanently lost.

PORTFOLIO LOGIC

Building and maintaining liquidity is only part of the path to stability. Tight financial markets have weakened the overall balance sheet for many companies, forcing management to consider more drastic measures to raise cash: exiting lines of business or selling assets. Today's liquidity challenges compound the portfolio uncertainty already facing management. Pending carbon legislation, volatile fuel and commodity costs, and the changing regulatory landscape have created a complex set of circumstances and trade-offs to consider before making strategic decisions to either invest in or retain assets.

The current crisis requires management to take a hard look at the current mix of businesses and assets to reaffirm each one's fit and contribution to the company's overall objectives. Management needs to ask: Do our business model, market positioning, financial contribution, and inherent capabilities align with the requirements for market success as we see them in the future? The fundamental reality of a credit crunch is that it points out that companies can

no longer support the lower-performing tiers of their asset portfolios.

Besides these strategic questions, the concept of business fit must also be extended to address questions such as the long-term viability of the business in light of today's economic environment. Both the short-term working capital and the long-term investment capital required to maintain and grow the business need to be evaluated against a robust set of scenarios that includes a prolonged period of constrained capital access, as well as a scenario in which the economy recovers more quickly. Evaluating risks in each business is imperative to determine whether management can absorb those risks in the current environment and is prepared to exercise its competitive advantage when the market turns around.

Ultimately, companies must determine whether shareholders are adequately rewarded for the risks inherent in each business or asset. A sober assessment of these areas will lead management to determine whether businesses and assets once considered core still carry the same value today.

WHEN OPPORTUNITY KNOCKS

As stated earlier, industry structure is reshaped during periods of discontinuity—and the fragmented utility industry will be no exception. Private equity and infrastructure funds can and will continue to provide capital to this sector (though with less flexible structures and terms than were previously available), investing in troubled companies and snatching up undervalued or distressed assets.

However, utilities can also view the current environment as an opportunity to pursue selective growth strategies in line with their core strategies. Strategic acquisitions are the flip side of rationalization, offering the benefits of scale, operating synergies, market access, and portfolio and regulatory diversity that previously may have been considered too costly to pursue. With the recent repricing of equity, there are bargains out there. Many companies are looking for the lifeline that strong, well-capitalized companies can provide.

Assets will also become available as portfolios are rationalized. More than 50,000 megawatts of generating assets have traded each year between 2005 and 2007. We likely won't see this level of activity this year or next, but assets will be available as financial and strategic owners reshape their portfolios to capitalize on or retrench from their current market positions. In addition, unfinished and

overscaled projects may create potential avenues for participation where developers are extended and short of cash. Recognizing these opportunities as others retrench may create future advantage during a period when competitors are hard-pressed to respond.

Companies with superior operating capabilities that can extend across larger asset bases and that have the ability to leverage proprietary insight about the markets where they operate should take advantage of today's environment, scouring the landscape and assessing whether opportunities lie in unsuspected or previously unavailable places. Businesses or assets with valuations that align with these points of view and result in a structurally advantaged position within each market can position a smart company for future growth and increased financial capacity and stability. While the industry didn't ask to be here again, another unsettling market (like that of 2002 to 2003) has emerged, providing opportunities to capitalize on this disruption and uncertainty.

No one can clearly foresee how this economic drama will ultimately play out. However, for the savvy and strategically focused company with a strong balance sheet, a cohesive portfolio, and a propensity to recognize opportunity where others don't, today's financial stress may pave the way for tomorrow's strategic success.

Utilities can view the current environment as an opportunity to pursue selective growth strategies.

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