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Annual Power Industry Forum (cont'd)

analyst coverage of utility stocks means that many smaller companies are not covered at all, noted Tirello. This, he argued, increases the likelihood of leveraged buyouts. New Harbor's Beatty noted that at the time of the **Unisource** LBO not a single Wall Street analyst was covering the stock.

Waiting For Equilibrium

For Generators, Contracted Plant Sales Is Only Game In Town

Owners of generation assets, driven by capital constraints and a need to repair their balance sheets, face a stark choice between selling merchant units at cents on the dollar or getting close to face value for contracted plants—assets that are often regarded as the crown jewels in any portfolio, **Rick Bowen**, executive v.p.-generation at **Dynegy**, told delegates. Sellers of contracted plants are looking to push debt maturities out beyond 'convergence'—when supply and demand return to equilibrium. "It's a gamble that most of us in the industry are playing," Bowen said. "It's the only game we have to play," he added.

And it could be a long wait for convergence. **Gary Hunt**, v.p.-consulting at **Henwood**, estimated that equilibrium won't return to western U.S. power markets until 2008, but in areas such as Entergy that date is probably closer to 2018.

One consequence of the dislocation in supply and demand is that generation owners will monetize what is effectively a call option on plants that have been mothballed, Dynegy's Bowen argued. Although plant owners still have to pay taxes on mothballed facilities, the associated emissions allowances and permits will almost certainly retain some value in the secondary market. Similarly, generation owners will take the raw equipment from unprofitable plants and ship it to areas where the economics are more attractive, such as Latin America. "One place I wouldn't want to be is the gas turbine market," he noted.

Conversely, for buyers of contracted assets the market dislocation is an opportunity to make low double-digit returns, according to **David Field**, managing director at **Bear Stearns**. The Wall Street firm, which recently agreed to acquire stakes in four qualifying facilities from **American Electric Power**, sees an opportunity in replacing above-market offtake agreements with lower cost power from the wholesale market and refinancing these assets, he explained.

Viewpoint

The Emergence Of Wall Street's Power Companies

History repeats itself in the financial community, but no one has seemed to notice, or remember, that way back in the go-go 1980s Wall Street's financial institutions also took more than a passing interest in getting into the physical energy business. At the time they either bought or had access to physical assets of oil refineries and hedged out their paper and physical risks. Companies such as **Salomon Brothers**' trading unit, **Phibro**, and trading company **Transworld Oil**, bought refineries and hedged production in the paper markets on the futures exchanges, such as **NYMEX**, or in the over-the-counter energy markets. In that way, they could speculate, but also had the physical cover to deliver petroleum products. Those days passed. The refineries were divested at handsome profits and Wall Street has now moved on to gas and power trading.

History Repeats Itself

Today, financial institutions are buying generation assets, and are also moving into the physical gas and power trading. This is reminiscent of their 1980s refining strategy. Moreover, Wall Street knows how to maximize the financial value of these undervalued generation assets. By this asset optimization strategy, they are covered in both the physical and financial markets, and will enjoy immense profits as the generation asset market rebounds in the future, likely in the next three to five years. Ironically, when this occurs, they most likely will re-sell these assets to electric utilities.

Staying On The Sidelines

While many energy players had expected foreign utilities and multinational energy companies to leap into the void left by the departing U.S. energy merchants and acquire undervalued generation assets and utilities, they have been hesitant to do so. Many foreign gas and electric utilities worry that the U.S. is a case of failed deregulation, an industry encumbered with murky and uncertain rules. They are gun shy to invest and are, at best, only nibbling around

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the edges. The big German utilities are either pulling out of the U.S. or sitting on their hands.

Meanwhile, the Asian utilities are watching and waiting. Big oil, which understands the energy value chain, should be buying utilities at these distressed prices. It certainly has the balance sheet to do so. But the oil majors are scared of being tarred and feathered as part "the big oil conspiracy theory" by both the media and much of the U.S.'s reactive and ill-informed public.

Reaction to today's high U.S. gasoline prices, where oil companies have been accused of price gouging, underscores this fear. For in reality, the oil markets are at almost record highs and gasoline prices must follow crude oil prices higher. But the public perception is that there remains an international big oil conspiracy that fixes prices.

The major oil companies know that they need to monetize the natural gas assets that they sit on around the globe. And many are going down the IPP route to meet this need everywhere but in the U.S., due to the political pressures and public perceptions highlighted above.

Wall Street

That leaves us with the financially astute Wall Street firms. They see bargain-basement distressed electric power valuations and have the financial wherewithal to move forward in today's uncertain and risky markets. But actually, given today's valuation levels, the risk that they're taking is minimal. There are over 200 GW of mostly gas-fired generation assets up for sale that are a screaming buy.

Why is that so? For one thing, we have been at the bottom of the market for the past six to nine months and much of the bad financial news from the electric utility and IPP sector has already come out.

While many buyers' and sellers' valuations remain far apart, banks have stepped into the void and are buying these distressed assets now. As demand picks up, generation surpluses will be burned off and values will rise.

Regional Recovery

The banks will not be long-term investors, but will divest these recently acquired assets as prices rises. This will occur at varying speeds, region by region. The nonsense of predictions that there will be a power glut until 2012 or beyond shows a clear lack of understanding of how much electric power is consumed in the U.S. For example, the Pennsylvania-Jersey-Maryland Interconnection is the third largest electric grid in the world. Size matters.

The ability to wheel power from areas of over supply to where demand is highest, also shows that the system is somewhat self-correcting when there is a supply-demand imbalance.

Secondly, there are many different power asset investment plays such as tolling agreements, anchor tenants, power purchase agreements and uncompleted plants that banks can exploit.

While the Federal Energy Regulatory Commission rewrites electricity market rules and is complemented by the intrusion of overly zealous state regulators, in actuality little has changed regarding the ultimate benefits of retail customer choice for electricity after all this financial carnage. The conservative cash-rich utilities that did nothing are now hailed as being "smart."

Competition has barely emerged at the retail level. That leaves wholesale trading and asset optimization as primed for market rebuilding. The meltdown of **Enron** et al took liquidity out of the energy trading market, and that liquidity is being slowly replaced by the financial houses.

However, *Humpty Dumpty* is not going to be put back together again in the same way. Circumstances have changed.

FERC, the SEC and the CFTC (plus the plethora of state public utility commissions) are now intervening in markets and are making the rules of the game just a little more complex. The market model that is evolving is one of quasi-regulated quasi-free markets. It is in essence a supply-balancing market, where credit and counterparty risks are scrupulously studied ad nauseum.

The new factors that must now be considered in any investment decision are the impact of the new rules for standard market design, regional transmission organizations, location–based marginal pricing, congestion management, and many other exogenous factors on the value of the underlying asset. These new factors are overlooked by valuation models of investment analysts. The regulatory model impacts both the P&L and trading. The U.S. power market is waiting to be reborn, and it is Wall Street that drives this train. Watch this space.

This week's Viewpoint was written by **Peter C. Fusaro***, Chairman of* ***Global Change Associates****, a New York-based energy risk advisory boutique, and co-author of New York Times best seller What Went Wrong at Enron and several books on energy trading (www.global-change.com). His company consults to hedge funds, investment banks, governments and energy companies globally.*

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