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Misreading liberalisation and privatisation: The case of the US energy utilities in Europe

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ABSTRACT

In response to energy market liberalisation and privatisation initiatives promoted by the EU and other European states in the 1990s, a large number of US energy utilities expanded their activities in Europe, mainly through acquisitions. The size of their investment was, a decade later, matched by the ensuing scale of their retreat, wealth destruction and often forced exit. Combining interviews, industry studies, published financial data and company reports, this article examines critically their strategy and, in light of widespread failures, seeks to answer the question of what went wrong. It is argued that mistakes might have been avoided through greater appreciation of how market liberalisation evolves given changing government priorities and general sovereign risk.

1. Introduction

Energy market regulatory developments on both sides of the Atlantic created conditions for international expansion by US energy utilities to Europe. International acquisitions involving public utilities represented in the 1990s a new and significant phenomenon which led to surprising business outcomes. US acquisitions in the electricity sector peaked in 1998 and 1999 according to industry studies: their estimated value was US$340 bn involving over 1150 transactions, with 55% of the deals by value and 46% by number being in Europe (Wiegand and Kruger, 2004). What sets the US utilities international expansion apart from similar initiatives in network-based industries is their sudden and costly entry and exit from Europe. Over a short period of time, 17 US energy companies (many of them counting among the Fortune 100) acquired a variety of assets, including generation, distribution networks and retail customers, and commenced gas and electricity trading operations. The companies were eager to take advantage of perceived market opportunities thought to be available through the planned liberalisation and privatisation of European electricity and gas markets.

These events suggest a host of research questions regarding the expansion strategy of US energy utilities which this paper will explore. The paper is structured as follows. Section 2 quantifies the scope of US energy utilities market entry and exit in Europe. Section 3 introduces the main research objectives and how they are reflected in the research methods used. Section 4 develops a theoretical framework which is applied in Section 5 to shed light upon US companies' investments in Europe, as revealed through the views and insights of former officials of various US and European energy utilities engaged in these cross-border activities. The last section concludes that the international strategy adopted by the US energy utilities arose out of a facile understanding of the potential opportunities created by recent moves towards energy market liberalisation, privatisation and deregulation. The main factors behind the US business failure and value destruction are summarised combining theory with empirical perspectives.

2. American investment in European electricity markets

2.1. Energy policy and the liberalisation of markets

The electricity industry can be sub-divided into four parts: generation, transmission, distribution and supply. Historically, in Europe these activities have been vertically integrated and operated as monopolies, many of them state-owned. Some European countries such as the UK and Scandinavian countries had, through privatisation and liberalisation, set in place reforms that resulted in the vertical disintegration of the industry in terms of ownership. In 1996, the EU promoted the Electricity Directive (96/92/EC) designed to break-up existing national integrated monopolies and create competitive energy markets by encouraging competition and equal or fair third-party access to grids and networks. It was argued that a traded market in electricity would promote competition, benefit consumers and provide energy security through adequate investment signals. These objectives

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were reinforced by the EU Gas Directive (98/30/EC) which required most member states to open at least a quarter of their gas markets to competition.

2.2. Quantifying the US presence in the European energy market

The move into Europe by US utilities was started back in 1989 by Enron. From 1989 to 2000, 17 US energy utilities entered the EU markets in an attempt to take advantage of anticipated business opportunities created by the liberalisation and privatisation programmes. These are listed in Table 1 and indicate the UK as their main destination where energy market liberalisation was most advanced. As a result, the paper concentrates upon events taking place in the UK energy market. As validated through interviews (organised as described in Section 3), most US companies viewed the UK market as a launch pad for further moves into Continental Europe.

The US companies varied significantly in terms of the size and scope of their activities as well as their European market entry strategies. For example, some US companies, such as Enron and AEP, operated in several energy sectors but the majority of US energy utilities combined only electricity and gas activities. Some limited themselves to electricity generation as such activities were supportive of trading activities. Others were traditional/mainstream utilities, which tried to replicate their home activities in Europe. According to several respondents, some companies sought to emulate energy trading in the fashion promoted by Enron. In other instances, an entirely *asset-less* strategy was conducted hoping that trading alone would be the source of profitability. Finally, some US companies were portfolio investors acquiring whole businesses and pursuing highly speculative strategies in Europe based on expected variations in asset prices over time.

Table 2 not only illustrates the diversity of the US energy companies but also highlights one characteristic shared by most US companies, namely the central role of energy trading activities. Although their priorities varied, almost all US companies relied extensively on power and gas trading activities, as opposed to solely owning and operating assets to produce and sell power. This is not surprising given that a key feature of EU initiatives was the creation of traded markets in electricity, which were designed to replace the aggregation role played by the system operator.

After a few years of acquisitions and expansion with extensive ownership, most US companies had left Europe by 2003. Most visibly, this withdrawal was most visible in the UK where most of the regional electricity generators, suppliers and distributors, previously US owned, now had been acquired by German or French energy utilities often at a fraction of the US acquisition price. For example, the AES Corporation bought Drax power station in 1999 for $3.1bn and sold it in 2002 for $1.1 bn to a newly formed Drax Power Group Plc, financed by private equity. In the process of entering these markets and subsequently exiting, it has been estimated that $20 bn in shareholders' wealth was destroyed (Helm, 2003) and, in many instances, these events led to high-profile bankruptcies in the US, raising issues of corporate governance. By 2003, the UK energy sector came under European ownership. As Tables 3 and 4 show below, all 17 US companies that entered the UK in the 1990s had exited within a decade or so.

The only US energy utilities operating in the UK today are 'late comers' who have taken over the assets from the 'first wave' of US investors: WPD and CEE Electric. Therefore, the 'first wave' international acquisitions by US companies in the UK were short-lived, failing to fulfil the hopes of investors and managers associated with such strategies. Having described what has happened, we turn to the data and methods used to explore why within a decade or so, a massive inward investment was followed by 'fire-sale' divestment.

Table 1
Chronology of US energy utilities entering the EU

Company	Year of entry	EU destination
Enron	1989	UK, Germany, Scandinavia
AES	1991	UK
Aquila	1991	UK, Spain, Germany
NRG Energy	1993	UK
Edison Mission	1995	UK
Mirant	1995	UK, Scandinavia, Germany
CalEnergy	1996	UK
GPU	1996	UK
PPL	1996	UK
AEP	1997	UK, Germany
Dynegy	1997	UK, Germany, Scandinavia
Entergy	1997	UK, connections to France and the Netherlands
TXU Europe	1998	UK, Germany
Duke Energy	1999	UK, The Netherlands
PSEG	1999	Germany
El Paso	2000	UK, Germany, Spain
Reliant	2000	The Netherlands, Germany

Source: The authors, based on data compiled from Platts, Companies' Records, Financial Press.

Table 2
Key US players in European Energy Trading

Company	Main fuel	Date of entry and first trading activities
AEP	Electricity/gas	Entered the UK 1997 (50% of Yorkshire Electricity); European Trading Office opened in 1999
Aquila	Electricity/gas	UK gas trading as United Gas since 1991; first Continental trading office in Spain, August 1999
Duke Energy	Gas	Established European HQ in London in 1999 and European Trading in 2000 after buying MEGAS
Dynegy	Electricity/gas	European trading since 1997 through Dynegy Europe, Ltd., London
El Paso	Electricity/gas	European trading since 2000, El Paso Europe Ltd., London
Enron	Electricity/gas/coal	In Europe since 1989, trading operations from 1996; entered UK in 1999 (a stake in Teesside Power Station); currently in liquidation
Mirant/Southern Corporation	Electricity	In the UK since 1995 when acquired SWEB; European energy trading since 1999
Reliant	Electricity	Entered Europe with purchase of the Dutch UNA in 2000; left in 2003

Source: The authors, based on data from Company Reports and Financial Press.

3. Data and methods

The experience of the US energy utilities is analysed using qualitative survey data against the background of quantitative information from public sources such as published financial accounts produced for the US Securities Exchange Commission and published energy market data found on the websites of various UK government departments, the US Department of Energy and the International Energy Agency, Paris.[1] The qualitative

[1] Published financial accounts for listed companies do not generally disaggregate performance to division level including the various subsidiaries which the US energy utilities launched in Europe. The qualitative information found in some reports provided anecdotal evidence on companies' plans and strategies overseas.