Consolidation in the Utility Industry

Successful Mergers and Acquisitions require C-level commitment to realize savings, reduce risk and capture the cash

Most people would never consider merging onto a crowded highway without an on-ramp, but many CEOs are doing precisely that when they enter the Merger and Acquisition (M&A) process.

Studies show that 50 to 80 percent of all M&As fail to deliver the value promised because executives are not looking at the oncoming traffic of a newly merged company. This results in decreased or flat profitability for the new company — most evident when year-end cash balances fall short of anticipated synergy savings.

M&As fail for a variety of reasons, including:

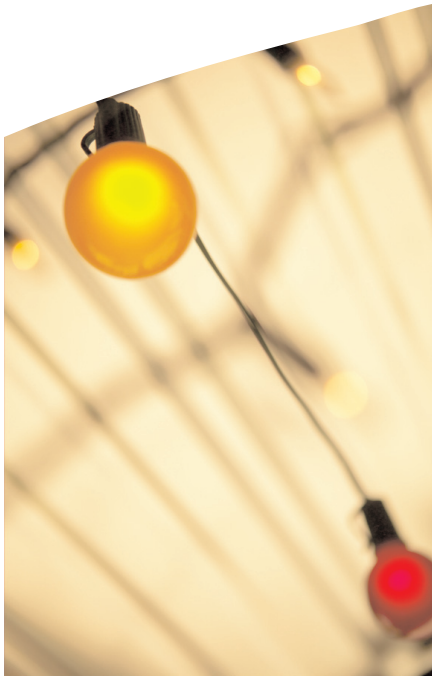
- Cultural incompatibility, change management issues, organizational confusion and division
- Overestimated synergies and insufficient focus on growth and revenues
- Inadequate emphasis on speed, leading to loss of integration momentum
- Flight of talent and knowledge capital or inability to transfer skills across organizations

Most of these crashes could have been avoided if executives had used an "on ramp" onto the M&A highway instead of driving recklessly. For many utility executives, Business Process Outsourcing (BPO) can be the on-ramp to successful M&As, paving the way to reduced risk, locked-in ROIC, investor confidence and long-term shareholder value.

Despite the number of failures, M&A activity, both in terms of deal numbers and value, is increasing. Even though the utility industry is performing well in the market, executives recognize the necessity to continue to increase shareholder and customer value through cost reduction and revenue growth.

Transformational M&A in today's favorable utility investment environment can provide the opportunity for forward-looking leaders to achieve both faster growing revenues and streamlined operations.

But these business benefits cannot be achieved without the *commitment of the C-suite* to transform the quality and reliability of business processes.



Provisions of the Energy Policy Act of 2005 are encouraging visionary leaders to look for growth through consolidation.

This means that executives must not only develop a plan for cost savings and allow operating management to focus on core operations, but they must also commit to an approach that will enable them to take full advantage of today's M&A marketplace. Large scale BPO is that approach.

For the utility industry, the business environment and timing are optimal for M&As. In the following pages, we'll examine the current M&A climate and how executives can best succeed in it.

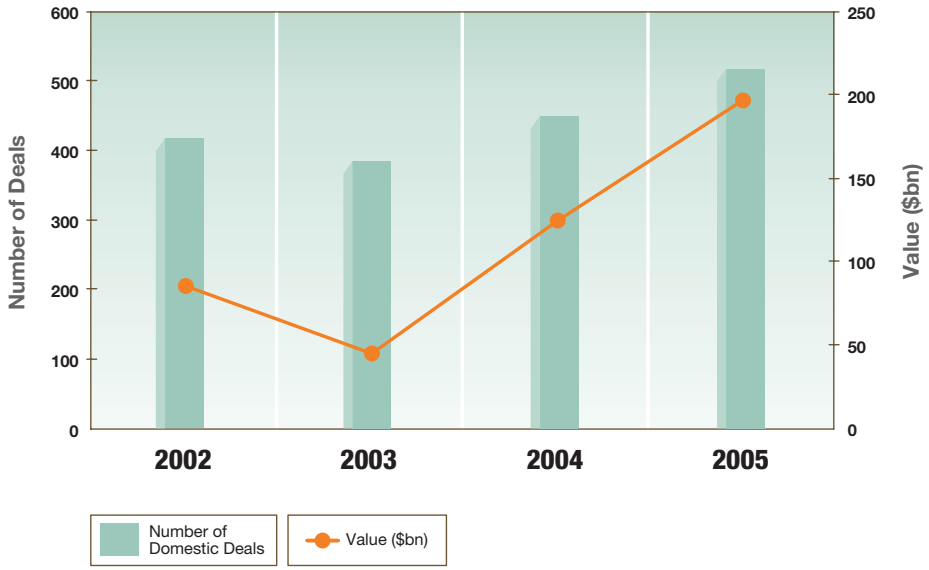
Energy Reform Favors Consolidation

The 2005 repeal of the Public Utilities Holding Company Act (PUHCA) has dramatically improved the investment landscape in the utility industry. By eliminating long-standing laws and regulations that have limited growth opportunities, provisions of the Energy Policy Act of 2005 are encouraging visionary leaders to look for growth through consolidation. Such growth will be necessary to create new energy sources, a more reliable grid, and better customer service. Given this more attractive investment environment, fewer organizations have the opportunity to improve their infrastructures, thus improving reliability — essential to prevent brown-outs or blackouts.

Consolidation is here to stay for years to come

In the U.S. today, there are more than 3,000 electric distribution companies, more than 500 transmission companies, and hundreds of electricity generating companies. The simple fact is there are too many regional, undercapitalized companies that lack the resources to lead the charge in consolidation. The utility landscape of the future will support only a smaller number of larger, stronger, better capitalized companies. Companies that are unable to grow will become memories.

Global Electric & Gas M&A



Source of Data: PricewaterhouseCoopers

Investment Opportunities

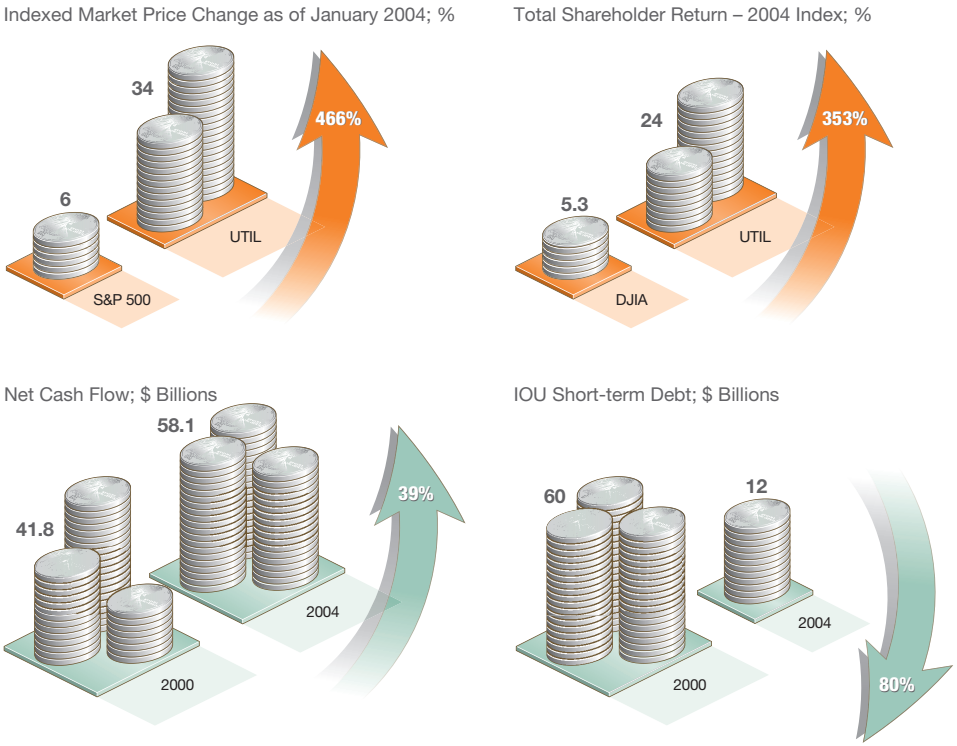
While consolidation in the utility sector is not new, the market has so far only dipped its toe into the full potential of investment opportunity.

In the U.S. alone, utility companies comprise more than four percent of GDP, representing more than $300 billion in annual revenues. According to the Edison Electric Institute (EEI), the sector has achieved exceptional financial performance in recent years, outpacing the overall market with substantial increases in market price, cash flow, and shareholder return, and a dramatic decrease in short-term debt placing utilities among the best-performing stocks in the S&P 500. The industry acknowledges that as executives and shareholders look to growth, utilities have become attractive investment opportunities, spawning a resurgence in M&A and an increase in average deal sizes, in the U.S. and globally.

Consolidation Requires a Commitment to Execution

By eliminating geographic and operational restrictions, the repeal of PUHCA further stimulates industry consolidation by opening investment opportunities to new players. For example, a public utility holding company's service area does not need to consist of a single integrated system. Companies with connecting networks can now become merger partners. Utility companies are freer to improve or deepen their commitment to core operations. They can now develop nationwide integrated strategies, shed "vertical" services and acquire additional resources to become larger, "flatter" organizations focused on increasing scale and revenues related to generation capacity or transmission facilities.

Utilities are High-Performing Stocks



Source of Data: EEI

Many mergers, however, result in disappointing financial returns and disgruntled shareholders, employees and customers. To benefit from perceived economies of scale and cost savings, these companies must address two fundamental challenges. First, they must resolve the complexities of combining the operations and maintenance functions and the "back office" support services of two or more companies into one integrated and smoothly running operation. And second, they must devise a workable plan for combining disparate corporate cultures into a new culture appropriate for the consolidated entity.

Capturing the Cash and Lowering the Risk

During the last few decades, the tantalizing lure of "synergies" created by integration and consolidation — especially the cost savings anticipated from staff reductions — seemed to justify one company paying a high price to acquire another. Unfortunately, research and experience reveals that expected synergies rarely materialize or are not sustainable. Oftentimes, in the months following a merger or acquisition, costs to deliver essential services often creep back up, and the value of the expected synergies rarely lasts.

In spite of strong leadership, extensive planning, aggressive change management, exhaustive due diligence and sufficient resources, more often than not, mergers continue to fail to deliver value. Clearly, a new approach is needed.

Because synergies are often neither attainable nor sustainable, leaders driving M&A activity need to look for more compelling ways to identify and achieve economies of scale and cost savings. Simply assigning expected "savings" targets to incumbent operating management teams with the expectation that they will deliver core operating objectives and cost savings has too often failed to deliver results. In addition, simply *promising* "synergy savings" to investors and Wall Street is not good enough anymore. The investment community today needs to be convinced of the value and risk mitigation in the transaction.

Simply put, continuing to execute M&A transactions the same old way won't cut it in today's business environment. Instead, management must be committed to a plan that will ultimately transform the new company in ways that deliver long-term business benefits and shareholder value. To accomplish this, executives are increasingly looking to third parties for guidance. And for many utility executives, these third parties are outsourcers with deep industry experience and expertise in helping utility companies achieve the full business value they anticipated from their M&As.

BPO — The On-Ramp to Successful M&As

Companies that provide transformational outsourcing solutions create an attractive consolidation alternative for decision makers, by providing an experienced team of industry, maintenance and technology experts who can deliver:

- Speed to market
- Flexibility in investing and divesting services and operations
- Immediate cost savings by streamlining business processes and locking in value contractually
- Reduced or shared risk

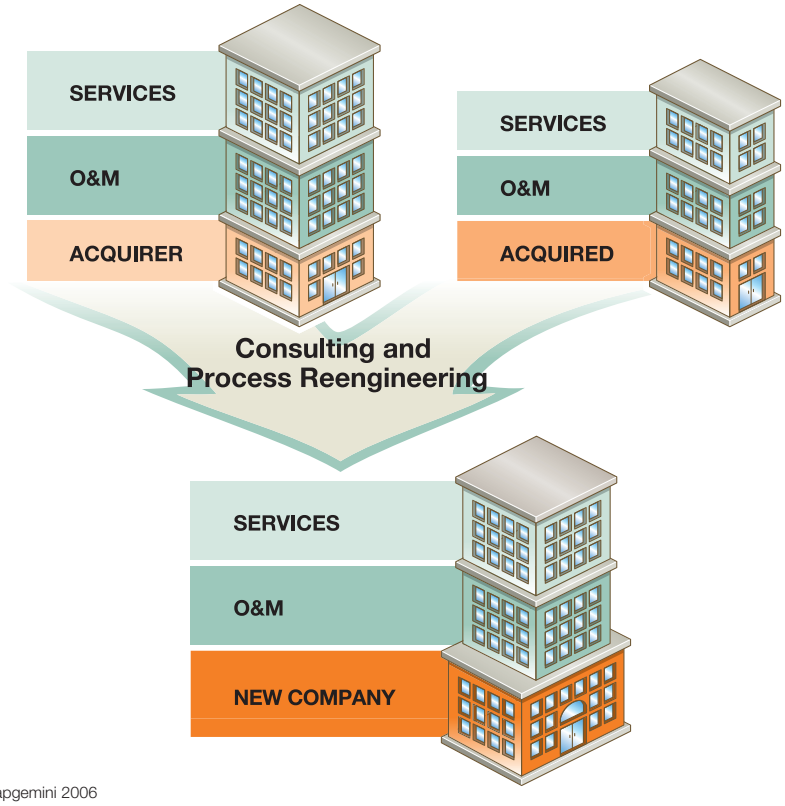
Companies engaged in large-scale BPO have an advantage since they are financially healthier, have deep experience with their clients' core businesses and can offer a flexible business model with the scale needed to move quickly in an M&A climate.

Is BPO right for all utility companies? More often than not, the answer is yes. In fact, by examining the following BPO models, the advantages of M&A become clear.

Model I represents the traditional approach to M&A transactions that frequently includes the use of consulting and process reengineering services. These services include project management, due diligence support, organizational redesign, process reengineering, change management, communications, performance metrics and tracking, regulatory support, technology consulting, governance and other services. Even when executed by a disciplined, dedicated team, this approach has a low success rate.

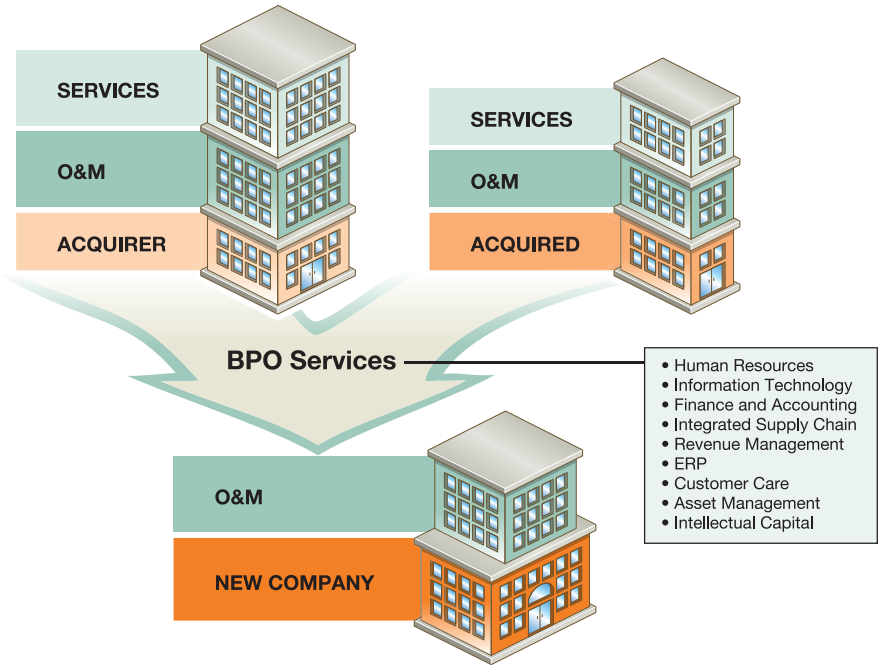
In Model II, the merged company maintains operations and maintenance functions in-house, but chooses a third party to handle corporate, back-office services — recognizing the opportunity to reduce risk and lock in savings by using an experienced provider of such services. Outsourcing firms usually offer a menu of BPO services and assist companies to determine which options are likely to create the most value and accelerate growth.

Model I: Consulting and Process Reengineering



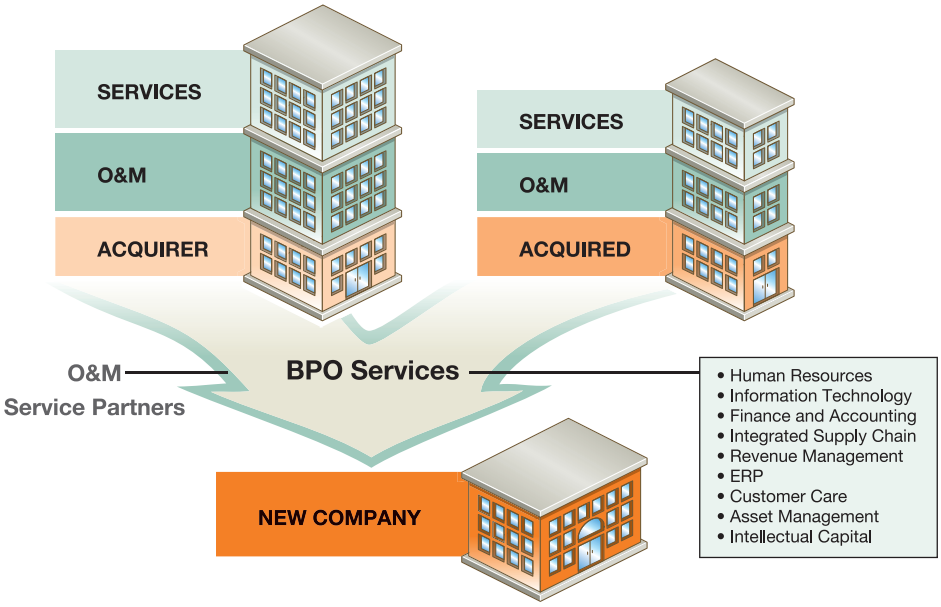
Source: Capgemini 2006

Model II: Outsourced Corporate Services



Source: Capgemini 2006

Model III: Outsourced Operations and Maintenance (O&M) and Services



Source: Capgemini 2006

Model III depicts a scenario in which the new company's owners want to own an asset, but do not want to run support services or operations and maintenance functions. Asset owners are able to focus on strategies, budget, regulatory issues and most importantly, shareholder value.

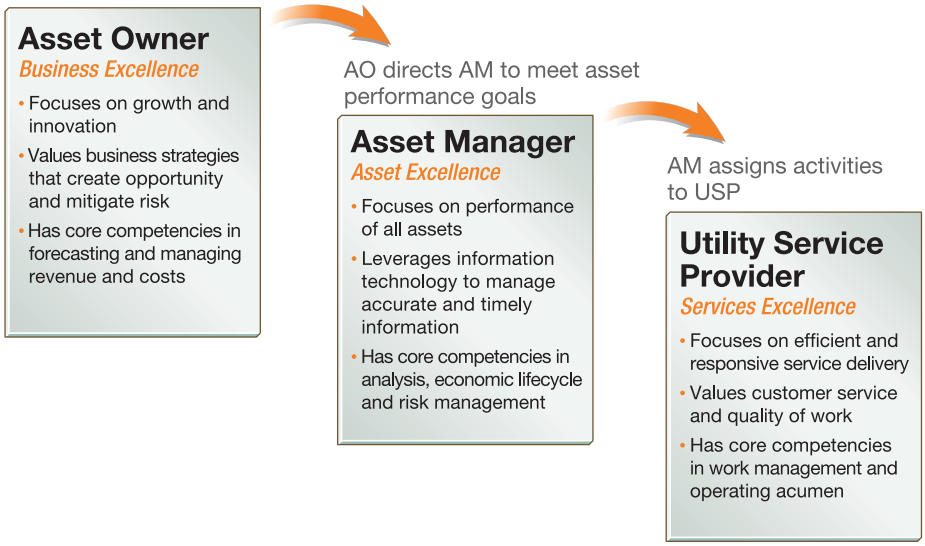
This approach will likely necessitate a collection of service providers, working as an alliance, since the required expertise can rarely be found within one firm. Already demonstrating tremendous success in the hospitality, commercial real estate investment and financial services industries, this is the model of the future for the utility sector.

But many CEOs do not stop here. Assertive and innovative leaders may choose to adopt a variation of Model III. Oftentimes, acquirers do not want the back-office assets or systems of the "acquired" company. Instead, buyers may want to use their company's own systems or the proven systems of a third-party BPO services provider — leveraging their scale or the scale of a third party and paying less because the transaction excludes IT assets. At the same time, both companies will benefit by maximizing their tax strategies and minimizing any negative impact to their respective balance sheets.

Due to industry consolidation, it is very possible that within 10 years there will be only a handful of utilities that are served by a handful of asset managers and service providers.

As these models suggest, the scope of services varies widely and depends upon the players. Experienced and competent service providers help companies understand options, articulate pros and cons, focus on creating value, lock in ROIC and mitigate risk.

The Future of Consolidation. The figure below shows the future of consolidation, where asset owners leverage other organizations for their core competencies.



BPO delivers sustained business value

BPO can help utilities achieve cost savings and economies of scale, while substantially reducing their risk. Instead of counting on synergies simply as a result of combining business functions, outsourcers take ownership of the functions, calculate savings at the beginning of the engagement and guarantee these savings, subject to the terms of defined quality and service levels.

Beyond the logistical and regulatory hurdles, the merging of disparate corporate cultures poses one of the biggest obstacles to M&A profitability. Tailored BPO solutions help guide a utility company through the many challenges and can help companies successfully navigate through the stages of M&As to bring sustained business benefits and shareholder value.

During the **transition period**, employees engaged in providing services or fulfilling operations and maintenance functions that are destined for service providers must swiftly become employees of the provider, receive new assignments, or receive help in seeking employment elsewhere. Complex issues such as transferring employees, tenure, and other HR issues must be well orchestrated and handled fairly to keep employees engaged. Extensive planning, industry-specific consulting services, change management services, HR solutions, and employee communications are an essential part of transition. Working with employees in a fair, equitable and open way is critical — retention programs to keep key players, guaranteed employment for a reasonable period, and severance packages are all important considerations.

During the **transformation phase**, business processes are redesigned to take advantage of innovative approaches. Providers will reengineer business processes to take advantage of offshore resources and capabilities, working out the specifics of staffing, information integration, training, handoffs, and other issues.

The **run phase** is based on the understanding that, while all of these issues are being addressed, services still need to be provided. BPO hinges on service level agreements that deliver industry-leading practices at costs lower than companies can achieve by integrating their own internal resources.

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Moving Forward

Energy reform has helped clear construction on what promises to be a busy highway of M&A activity in the utility industry. In fact, circumstances have never been more favorable for consolidation. As the traffic builds, some utilities using the uncontrolled approaches of the past, will inevitably crash. Meanwhile, other companies, taking advantage of the "on-ramp" approach of BPO, will merge smoothly and successfully, achieving lasting business benefits and sustained shareholder value along the way.

Why Capgemini

Industry Expertise. With more than 10,000 consultants dedicated to energy, utility and chemical projects across Europe, North America and Asia Pacific, Capgemini brings industry-specific experience to help address the complex business issues that executives face.

Global Outsourcing Leader. Capgemini is the global leader in developing closer, more effective, trust-based outsourcing relationships that deliver better, faster and more sustainable results. No other service provider matches the range and flexibility of Capgemini's intelligent mix of solution portfolio, commercial model or delivery location options. Capgemini's innovative Rightshore™ approach means having the right resources, in the right location, and at the right cost. As our clients' needs change, we provide flexible and scalable solutions through over 100 integrated delivery centers globally.

Trusted Partner. Capgemini is the results-driven business partner trusted by leading companies. For TXU, transformational business process outsourcing with Capgemini has led to more responsive customer service, a substantially reduced debt load, a much more efficient cost structure, and significant gains in shareholder value. Through distributed delivery, new technology, and more consistent end-to-end processes, Capgemini is helping TXU and other utility companies to transform their businesses.

About Capgemini and the Collaborative Business Experience

Capgemini, one of the world's foremost providers of Consulting, Technology, and Outsourcing services, has a unique way of working with its clients called the Collaborative Business Experience.

Backed by more than three decades of industry and service experience, the Collaborative Business Experience is designed to help our clients achieve better, faster, more sustainable results through seamless access to our network of world-leading technology partners and collaboration-focused methods and tools. Through commitment to mutual success and the achievement of tangible value, we help businesses implement growth strategies, leverage technology, and thrive through the power of collaboration.

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