NEW POWER eXECUTIVE

Friday, May 10, 2002 Vol. 6

Final Report on DISCO's Future From CAEM

Sometime Next Week, Members of NARUC and MACRUC are likely to receive a package from DC Public Service Commission Chairman Angel M. Cartagena Jr. Enclosed will be the just-released Final Report of the Distribution Company (DISCO) of the Future and a note from Cartagena urging them to "at least skim it, then let's talk."

"Those of us in state regulation who buy into the vision of competition as a way to bring energy services and reasonable prices to ratepayers in the future need to speak up clearly and loudly every chance we get," Cartagena says.

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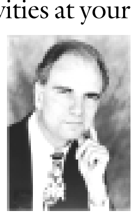
Power Moves

What, Me Socially Useful?

By Dr. Robert Michaels, CalState Fullerton

Mad Magazine's Alfred E. Neuman can be happy that the killer documents have finally surfaced. Do you have funny names for everyday activities at your shop? Instead of calling them "Get Shorty" or "Death Star," go all the way and say "the red fish fly at midnight." You do something that countervails a buyer's market power that brings power into areas where it's scarce? Call it "Inc-ing." Whatever you do, don't bother explaining.



This week's internal memos by Enron's outside attorneys are more significant for what they say about the rest of us than for what they say about Enron. They are about our near total lack of in-

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Market Intel Desk

Vivendi – What Went Wrong?

By Diane Borska, managing director, The Borska Group

It appears Vivendi Chief Executive Jean-Marie Messier will soon join the ranks of Jeff Skilling and Ken Lay. No, no, no, not in the courtroom or at the hearing table, but amongst a group of CEOs that belong to the "yesterday-a-visionary-today-a- disgrace" brotherhood. Messier's ticket to this less than exclusive club comes in the wake of a publicly hostile shareholder meeting, a seemingly endless stock price slide at his pride and joy, Vivendi-Universal, and a bruising downgrade of Vivendi Universal's staggering-by-any-measure debt load by – you guessed it – good ole Moody's. These problems have been accompanied by repeated calls for the sale of his utility holdings, the 63 percent stake in Vivendi Environment. The calls come amidst persistent rumors that Vivendi Universal will spin off its US-based entertainment holdings with leadership to be assumed by none other than the crafty, yet patient Barry Diller.

So what went wrong? A French powerhouse with dominance in water and wastewater utility operations and services, that expanded into power generation with a substantial stake in Sithe Energies as well as energy services through a joint venture with EdF, decided to expand away from its core and enter the more glamorous but dangerous world of media and entertainment. The idea was simple and one that a lot of us flirted with in the late 1990's – use the strong and stable cash flow from the low-growth utility business to fund expansion into higher-growth yet riskier businesses. That's how a lot of the players currently dominating today's energy scene arose, right? The difference was, of course, that Messier put his cash flow toward the building of a media empire.

Oh, you say dismissively, "how can a utility executive expect to manage the difficult and hit-or-miss world of media?

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Northeast, Ontario New M&A Hub

A special to New Power Executive from the Editors of Io Energy's PowerDaily Northeast

Merger Mania in the North American Electric Utility Industry has subsided now for a number of reasons, according to a top manager at Accenture, but selected sales and purchases of individual assets should continue.

Etienne Deffarges, global managing partner of Accenture's utilities industry practice, said the North American utility industry, with more than 60 companies that each have at least $1 billion in assets, remains too fragmented as compared to other "network" industries such as telecommunications, airlines and railroads. Regulatory obstacles, both federal and state, and tradition kept many utilities relatively small. Utility mergers picked up in the 1990s, and in the late 1990s, several multistate combinations emerged, such as American Electric Power, Dominion, Duke Energy, Exelon, FirstEnergy, National Grid USA, NiSource and Xcel Energy.

The pace of mergers has slowed dramatically.

"The Enron affair basically stopped people dead in their tracks,"

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Terzic on Strategy

Eastern Approaches

By Branko Terzic, Deloitte & Touche

Energy companies looking for international investment opportunities should now be developing their dossiers on the formerly Communist-controlled countries of Central and Eastern Europe. Reasonable regulatory environments, a key precondition to successful utility infrastructure investment, are being established with assistance from US and European regulators. That is the main message from the 1St Annual Investment and Regulation Conference held by the Energy Regional Regulators Conference in Budapest, Hungary, April 25-26, 2002.

The keynote address was delivered by the president of the European Bank for Reconstruction and Development, Jean Lemierre. His speech also set the tone of the conference when he stated that the single most important determinant for the future economic development of the countries of the region will be how they handle the energy infrastructure regulation and privatizations. The importance of the subject and the establishment of regulation was confirmed when the EBRD president

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Deffarges said, explaining that Enron's collapse has scared potential buyers away from companies invested in an energy trading operation. A second reason for the slowdown in mergers is that a glut of new power generation assets has driven down margins so that little money can be made in wholesale markets. Third, Deffarges said, utility executives have gotten more careful. When they state a preference for a regional focus, likely merger partners are limited, and personal issues sometimes come into play that can seal or break a deal. Over the next year or two, Deffarges said, deals will be more similar to St. Louis-based Ameren's proposed purchase of neighboring utility Cilcorp, parent of Central Illinois Light.

Cilcorp's owner, AES Corp., needed to sell an asset with value to raise much-needed cash, and Ameren, which already has a substantial presence in Illinois, is familiar with the political and economic characteristics of the new company's service territory. In North America, Deffarges said the most likely regions for continued asset transactions are the midwestern and northeastern United States, plus Ontario. He predicted Canadian companies could come into the United States, or vice versa. Either way, he said, a deal could be structured to enhance transmission transfer capabilities between the United States and Canada.

Likely buyers might not necessarily be within those regions, but would be companies that are prudently managed, and have balanced portfolios and ready access to cash. Among them would be AEP, Dominion, Duke, Exelon, Southern Co. and TXU, Deffarges said.

Acquisitions by European utilities are also likely, though Deffarges said the Enron collapse has slowed some potential deals. "Had we not had the Enron problem, I think companies from Germany would have bought a US electric company by now," he said, noting that German utility RWE has acquired a US water utility, along with opening a US power trading operation.

Other German and Spanish utilities have been reported to be interested in US acquisitions, but Deffarges said that is less likely because they are relatively unfamiliar with the energy trading business and have language differences. Far more likely is another move by a British utility; three already own substantial US utility assets. Deffarges said National Grid, which has already acquired three utilities in New England and New York, still has an appetite for more US purchases.

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terest in explaining to the world exactly what it is that we do, why it's socially useful and why the old system was badly overrated. When reporters call, we take the easy way out and send them to an underling, who first describes the abstract wonders of competition and goes on to explain that the details are highly technical and in the hands of the lawyers anyway.

When the memos came out a few days ago, we got the level of press coverage we deserved. Forget about supply, demand and price. Just the names attached to those incomprehensibly structured transactions were enough to prove that it was all Enron's fault, and *The Los Angeles Times* and *Wall Street Journal* practically said so on their front pages. A couple of days have passed, during which I and others took some hours to walk reporters through the history, market structure and transactions. At times it has been frustrating, but every so often I sensed a light bulb starting to glow at the other end of the line.

A waste of time? Check out those two papers a couple of days later, where articles now give space to the ordinariness and potential efficiencies of the transactions. (Also check out *The New York Times*, which as of today remains totally clueless.) Why worry about the delayed understanding? Look at *The L.A. Times* editorial just after release of the memos. Its content will underlie the opinions of all too many influential people who were too busy to read the later stories in much detail. It refers to "Enron memos" (actually outside counsel documents) that "go on in pages of sneering, 'gotcha' detail about such things as how to get paid for not putting any energy on the grid," and concludes that the state's original demand for $9 billion in refunds is "just about right."

Producers and traders earned this treatment by letting utilities and anti-market people move first. Electricity has been a politicized industry since the first city council let a favored campaign donor put its posthole auger in the ground, but competitive ideas usually come from people whose minds do not give equal space to politics. Most of us thought we had nothing to explain because the superiority of competition was so transparent – all you had to do was look at the Soviet Union and the Post Office. For all of Enron's faults, it (like the utilities) correctly understood that in electricity's situation there had to be both market and political deals. The rest of us still can't really swallow that one.

The guys from the Cato Institute are right when they say that Enron was at times less interested in bringing competition than it was in working with officials to get favored treatment. Making friends with reporters was a necessary part of its strategy, and in this business it would have made just as much sense for a financially spotless company. If Enron hadn't slipped, we would have many more friends in government and the media today, an affirmative high-budget defense that could take the offensive on Get Shorty and Inc-ing, and a lot more of a future than seems likely now. There was only one Enron, a lesson on diversification none of us really needed to learn.

Bob Michaels is Professor of Economics at California State University, Fullerton and a consultant affiliated with Tabors, Caramanis & Associates of Cambridge, MA. The views expressed in this column are only coincidentally the professional opinions of the author, his affiliations, or their clients. Contact Michaels at rmichaels@fullerton.edu.

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(FINAL REPORT ON DISCO'S FUTURE from page 1)

MACRUC interest is key, he says, because jurisdictions in PJM territory are prime examples that the transition to competition, while not perfect, works.

The report of the forum, a 50-person Who's Who of both regulators and industry, is essentially a policy document that offers "consensus-based" solutions to increased risk in the competitive electric and gas distribution business. CAEM President Jamie Winberly says the group spent a year deliberating. He called for further debate on the report's conclusions.

What did they come up with? Two hundred findings and recommendations that are designed to serve as a blueprint for the future of the industry. Big picture, the group says wholesale and retail energy competition is the way to go. DISCO firms can work if regulators allow them to recover reasonable costs plus "a reasonable return on invested capital, commensurate with the risks associated with operation under the selected business model."

While the findings are consensus-driven, it's not surprising that consensus was not easy to reach. The group clashed on the correct business model for distribution firms (the report outlines four), whether regulated DISCOs should or could participate in the competitive market and whether unregulated DISCO affiliates should be allowed to operate in that DISCO's franchise territory.

Among the extensive recommendations are a couple related to risk management. The group found that, while hedging is available, regulatory obstacles prevent DISCOs from using it, because a risk premium is required for hedges on provider of last resort and default service. The forum says that each jurisdiction should clearly state its intentions to reduce regulatory risk and ensure that the market participants who bear the risks are those most able to manage them. Each jurisdiction should ensure that prices include a risk premium and that "the risks and rewards for managing risks are equitable."

The group also suggests incentive ratemaking as a cost-lowering technique for DISCOs, the removal of competitive barriers to time-of-use and real-time metering and an anti-trust investigation of flexible pricing, as well as the granting of merger oversight authority to regulators who lack it. The report urges regulators to consider a variety of policy options on the restriction of market participation by utilities and their unregulated affiliates. It advocates the use of e-commerce by regulated DISCOs, but calls for standards on data exchange between regulated and unregulated entities.

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The complete findings and recommendations can be downloaded as part of the full report, available free of charge at www.caem.org.

CAEM also released its latest Retail Energy Deregulation (RED) Index, a twice-yearly scorecard on the move to a competitive retail energy market. Texas has seen the biggest improvement, representing "a new, large coherent retail market [that] may benefit from its integrated retail and wholesale regulation by the PUC of Texas. Within the Electric Reliability Council of Texas, the PUC has the opportunity to enforce consistent and coherent wholesale and retail rules on a scale comparable to a small country." But with an average score of 25 out of 100, the states still have a long way to go in competitive energy, the report says.

With more than half of the states making inroads to competitive markets, "regulators are vitally concerned about making what they've done successful," says CAEM's Wimberly. "Regulators are keenly aware of some of the problems and are groping to understand how to make it work. This report nicely lays out a series of issues that can be applied to an unbundled DISCO in a competitive market [but] also points out a lot of the changes occurring, unregulated or not…We believe it is inevitable that ultimately we will be in that [competitive] situation. There's no going back."

Forum member Steven Agresta, who heads the energy group at Swidler & Berlin, decried the lack of help from an administration led by the former governor of the state that's leading the pack. "States have an unbelievable challenge," he says, "and no federal leadership."

Contact Wimberly at 202/496-4972 or jwimberly@caem.org.

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agreed to attend and speak and by the fact that he was followed on the program by the EBRD's director of power and energy utilities, Anthony Marsh.

Providing a visible sign of support from the energy regulators in the EU was a presentation by the president of the Council of European Energy Regulators (CEER) and member of the Portuguese regulatory agency commission, Dr. Jorge Vasconcelos. Other European regulators presenting at the conference were Commissioner Dr. Sergio Garriba of Italy and Commissioner Juan Ignacio Unda of Spain. Pedro de Sampaio Nunes, director of conventional energies directorate general for energy & transportation, represented the EU on the program.

US support for the newly created organization of Central and Eastern European regulators was evidenced by Dr. Richard F. Ichord Chief Energy & Infrastructure USAID and National Association of Regulatory Commissioners President William Nugent both of whom were on the program. The US regulatory delegation included NARUC International Committee Chairman Fred Butler of New Jersey.

The themes of the conference were 1) that private capital is needed to expand, upgrade and improve the energy infrastructure in the region and 2) that the members of ERRA are establishing regulation in their countries which will welcome investors by creating a regulatory environment which will treat private investment fairly. Looking ahead to joining the European

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It's a classic case of "you'll get burned if you move too far from the core business." And I say that's an overly simplistic analysis. A more thoughtful look at Vivendi's history in the context of European, particularly French, but also German conglomerate building suggests there is a bit more to this story.

Vivendi was founded as Paris-based Compagnie Generale des Eaux (CGE) in 1853. CGE even at that time was a global company, managing the water system supplying the French cities of Paris and Lyons, as well as obtaining contracts to manage water systems in Venice, Italy, Oporto, Portugal, and Constantinople (now Istanbul), Turkey. Although many assume its first exposure to the media world was its 2000 acquisition of Seagram's (major shareholder of Universal), CGE entered the world of media back in 1983 when it joined another French stalwart, media group Havas (publishing and adverstising), to establish the Canal + pay television operation. Again, predating its Seagram acquisition, CGE ultimately became Havas' major shareholder, acquiring a 30 percent stake in 1997 and the whole company in 1998.

Through the early 1980s, CGE continued with its diversification activities. It established a mobile phone network in France (Cegetel), sold a large health care business, entered into a joint venture with Vodaphone and acquired railroad and road service operations in Germany and Scandinavia. Some noteworthy transactions for those of us in the energy space were its 1980 acquisition of energy services company Compagnie Generale de Chauffe, its 1983 co-founding of US-based IPP Sithe Energy, and to a lesser extent, its 1988 acquisition of global constructor Societe Generale d'Enterprises.

By the 1990s, CGE was a true multinational conglomerate. It was operating in more than 90 countries with 235,000 employees. Its portfolio of businesses included waste management, transportation, energy, construction, property development/management and communications. During much of CGE's expanision, the now infamous Messier was not with CGE. In fact, Messier is anything but your typical utility executive and his background is more like investment bankers David Wittig of Western Resources or Mayo Shattuck of Constellation, who took the helm at a utility after a distinguished career on Wall Street. While CGE built its conglomerate through the early 1990s, Messier served a tour of duty at France's Ministry of Finance, where at a young age, he headed France's privatization of state-run companies. After leaving government with the reputation as a financial whiz kid, he became an investment banker, making partner at Lazard Freres at the ripe old age of 32. He gained notoriety by launching one of Europe's first LBO funds and was well-known for his ability to dissect a company financially – perhaps a foreshadowing of his activities at Vivendi.

In 1994, Messier was asked to join the board of CGE and he was not yet 40 years old. At that time, the company was said to be teetering on the edge of bankruptcy and in need of strong financial management. Messier was reportedly instrumental in developing a plan for divesting non-core assets to raise cash and redeploying that cash into higher-growth, higher return telecommunications and media businesses, including the 30 percent stake in Havas. In 1996, he was named CEO of CGE, in recognition of his successful financial reengineering of CGE. In 1998, presumably with an eye toward redirecting his international media conglomerate, Messier renamed the company

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Vivendi and acquired the rest of Havas along with Cendant Software, in the wake of their financial scandal.

In 2000, all eyes were on Messier's eye-popping $34 billion deal to acquire Seagrams cementing Vivendi's role in the New York/Hollywood-based media world. Before, during and after that deal, Messier worked hard to restructure Vivendi, as part of financing this enormous acquisition. Following his successful 1996 formula, Messier determined which of Vivendi's businesses were non-core and candidates for divestment, thus cash-raising. Although interested in the growth potential of the utilities and energy, Vivendi determined that its Dalkia (www.dalkia.com) energy services venture with EdF was its greatest interest and that power generation development was not. By late 1999, reports began to surface that Vivendi was looking to divest Sithe, culminating in deal it cut with Exelon (then Peco) in late 2000. Lest you think that all Messier did was buy Seagrams and dump utilities, Vivendi also decided the water and wastewater services were an important growth area, and in March 1999 acquired US Filter for $6.2 billion in cash.

By selling 49.9 percent of Sithe to Exelon for $696 million at what could arguably be considered the near top of the market, Vivendi rasied net proceeds of $475 million. In 2000, Vivendi, as expected, divested the wine and spirits business of Seagrams for $8.1 billion and also began divesting its interests in engineering and construction. In this same year, Messier reorganized Vivendi into two companies – Vivendi Universal for the media and telecommunications assets and Vivendi Environment for the water, energy and utility assets. Messier offered about 37 percent of Vivendi Environment to the public in a 2000 IPO, retaining 63 percent ownership of the company at the Vivendi Universal level. Sounds reasonable, right?

All during this time, and through the first half of 2001, Messier was held up as an icon, a genius, a true visionary. His ego, already more than healthy, reportedly became as legendary as his reputation. Then what happened? It's an old story by now. The dot-com bubble burst, telecom went into the toilet, the stock market sank, Enron's collapse put greater scrutiny on debt load, placing a premium on liquidity and Messier got squeezed by it all. As the market collapsed, and Vivendi's stock price along with it, Messier was left explaining to his shareholders the future for a company with a crippling debt of something like $15 billion and a share price has fallen almost 50 percent so far this year. Vivendi Universal reported a net loss of $15 billion for the first quarter after writing down about $15 billion on its media assets, all but an admission that it overpaid for most of what it acquired in this area. Moody's struck in early May, downgrading Vivendi Universal's debt one notch to Baa3, one notch above junk. Oh, and did I mention there are some pesky off-balance sheet obligations with equity price triggers that amount to more than $1 billion as well...sound familiar? Sound like Williams and Mirant and Calpine and ...?

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Now let's add the last chapter of the story. Vivendi Environment is supposed to be the reliable, stable cash cow in this tale, right? Well, as one clever journalist put it, that cow is refusing to be milked. Right on the heels of the Moody's downgrade of Vivendi Universal,.Vivendi Environment announced its intention to acquire UK-based Southern Water from First Aqua Holdings, a deal that has reportedly been in the works since March. Vivendi Environment will acquire a 20 percent share of Southern Water from First Aqua for about $600 million, valuing Southern Water at $3 billion. The rest of the equity will be purchased by thus far unidentified "financial partners." By the way, Vivendi Environment, which assumed a great deal of debt accumulated by what is now Vivendi Universal at formation, has a current debt load of close to $13 billion.

Coming at a time when the parent company needs to raise, not spend cash, this pending acquisition has been said to be putting an almost irreparable strain on the Vivendi Universal-Vivendi Environment relationship. And that's what motivates the current breakup vision for Vivendi, one that Messier, by the way, reportedly does not support. The breakup scenario some contemplate would leave Vivendi as a pure media company, with virtually no debt. Analysts believe this could be achieved through the sale of its telecom interests along with the remaining stake in Sithe and some other unrelated investments. The second part of the scenario involves a full de-merger of Vivendi Environment. This would be a difficult deal primarily because the French government objects to foreign control of its water utilities (how's that for ironic?) and would object to the obvious acquirers of RWE and EON. A rumor surfaced just this morning that Vivendi Environment is in talks with Air Liquide for some kind of merger, but that rumor has been quashed so far by both Vivendi and Air Liquide.

So I'm not sure the moral of the story is that conglomerates don't work. In this case and in others highlighted in the press of late, they haven't. But I think it's more a case of carefully financing these structures and closely managing both debt and the risks of declining market conditions. Failure is not a result of flawed vision, but success seems to come more from the careful, tedious, accounting drudgery that these complex corporate structures demand.

Diane Borska is a leading market analyst and strategic market support consultant. She can be reached at 617/592-7301 or e-mail her directly with your questions or comments at borska@rcn.com.

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Union, every one of the presenting countries also demonstrated a desire to make their electric and gas industry structures and regulations compatible with the new European Union directives calling for "liberalization" and the introduction of competition in energy supply.

Another indication signalling a good regulatory environment is the high caliber of individuals appointed to these new regulatory agencies. In reviewing the biographies of the newly appointed regulators, and in personal discussions, it is apparent that most governments reached the same conclusions about who to nominate for the first round of appointees – individuals that have as a prerequisite a deep knowledge of the industries to be regulated. Thus the newly appointed regulators are almost universally technically trained in the energy industry with extensive experience in design, operation and coordination of energy infrastructure. Later the pool of talent will widen as it has in the US and individuals with other professional training will surely be selected.

The irony, of course, is that today in the US, a country with the longest experience in regulation of private monopoly, it is almost impossible, in some states, to appoint someone to a regulatory commission who has experience and background in the electric and gas industries. This was not the case when regulation was established. Perhaps the pendulum will swing back.

Terzic, based in Washington, DC, heads the Central European Energy and Utilities Practice for Deloitte & Touche. Previously, Terzic served as a FERC commissioner and utility CEO. He can be reached at bterzic@deloitte.com.

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