Utilities primed for M&A revival

Search for cost cuts, nuclear assets could kick off activity

By Stephanie I. Cohen, CBS MarketWatch
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WASHINGTON (CBS.MW) - Electric utilities, stymied by high operating costs but eager to expand their business, are poised for what analysts say could be a hot year for mergers and acquisitions.

And Exelon's bold takeover bid for PSEG has whetted their appetite.

"The late 2004 merger of Exelon and PSEG and the positive reaction of both stocks will likely spur more [merger and acquisition] activity," according to a Merrill Lynch research report released on Wednesday.

The trend is further fueled by higher fuel costs and costly upgrades to aging power systems. Analysts say combining operations gives utilities with heavy debt levels a way to grow.

Last month, Chicago-based Exelon Corp. (EXC: news, chart, profile) announced it was buying New Jersey's Public Service Enterprise Group (PEG: news, chart, profile) , creating the nation's largest utility holding company.

Other merchant power companies openly touting the benefits of consolidation in the sector include Duke Energy (DUK: news, chart, profile) , NRG Energy (NRG: news, chart, profile) , and Dynegy (DYN: news, chart, profile) , Merrill noted in the report.

Analysts at ABN Amro highlighted more than half a dozen utilities that are well positioned heading into 2005 to hunt for bargains and assets, including American Electric Power Co. (AEP: news, chart, profile) , Dominion Resources (D: news, chart, profile) , Duke Energy (DUK: news, chart, profile) , Entergy Corp. (ETR: news, chart, profile) , FPL Group (FPL: news, chart, profile) , TXU Corp. (TXU: news, chart, profile) , and MidAmerican Holding Co.

Those companies may see mergers as an option "because they've run out of other things to generate some kind of growth story," said Peggy Jones, an analyst with ABN Amro and an author of the report.

Utilities will not be alone in their pursuit of mergers this year with increased activity expected across several industries following on the heels of 2004, the busiest year for mergers and acquisitions since 2000. See full story.

Merger activity in the power sector hit a four-year high of $50.8 billion last year, though more than half of it stems from Exelon's bid for PSEG, a merger valued by Thomson at roughly $27 billion including a $12 billion stock swap and assumed liabilities of PSEG.

This level still falls far short of the roughly $74.9 billion in power sector mergers seen in 2000 at the height of the power trading boom.

Congress could help kick off a consolidation rush in the power sector with the passage of legislation repealing the Public Utility Holding Company Act, a 1930s era provision seen as an obstacle to utility mergers and backed by key Republican lawmakers wielding a wider majority in the House and Senate this year.

Nuclear power beckons

Characteristics of potential buyers are a history of success running nuclear operations, strong market capitalization, aggressive management, and success in maneuvering through regulatory proceedings, according to ABN Amro as

Utilities that could fit this bill include Dominion, Duke, Entergy, and FPL, according to the ABN Amro report released on Tuesday.

A number of these companies also have experience shopping for merchant generation.

Companies that might be ripe for acquisition include Allegheny (AYE: news, chart, profile) , DPL (DPL: news, chart, profile) , LG&E Energy (EON: news, chart, profile) , Pepco (POM: news, chart, profile) , and TECO Energy (TE: news, chart, profile) , the report said.

First Energy, with nuclear assets that have been "chronically difficult for management to deal with in the most effective way," most recently in the form of the Davis Besse nuclear plant in Ohio, could attract a company with an eye to improving performance, the report noted.

A similar strategy was at the heart of Exelon's decision to purchase PSEG, which has a stake in three nuclear plants. Exelon believes it can increase the output of these plants.

"A company with underperforming nuclear plants will certainly be targeted if their stock price drops," Jones said.

Constellation Energy Group (CEG: news, chart, profile) , an experienced nuclear operator with more than $2 billion of cash and credit availability, could fall into either category, ABN Amro said.

But the increasing interest in merger and acquisition activity in the utility sector comes with potential rating implications, Standard & Poor's warned in a report on the sector released Tuesday.

The ratings agency pointed out that it has issued ratings actions on a number of utilities involved in mergers and acquisitions included Exelon, PSEG, and AGL Resources (ATG: news, chart, profile) .

In the case of Dominion, Standard & Poor's warned that it is "concerned that the company's aggressive acquisition strategy could result in an eventual weakening of its business profile."

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