

E.ON in 2008

In 2008 E.ON was a large and leading European utility company that had grown successfully from being a regional German power generator. It had enjoyed years of success. However, after a period of successful expansion, the Board needed to review the portfolio and corporate strategy. The potential for increased competition in the gas business, and the risk of decline in its core German generation business threatened profitability. New businesses had been invested in – but they needed to be developed to become strong and profitable.

The Power and Gas business in Europe

The power business value chain included fuel supply (coal, gas, nuclear, oil or wind), conversion to electricity (in power plants), trading of wholesale power, high voltage grid transmission, low voltage grid distribution and retailing to large, SME (small and medium enterprises) and residential customers. The gas business value chain involved exploration and production (typically conducted by large oil and gas companies), gas trading, long distance pipelines, national high pressure gas grids, low pressure distribution systems and retailing.

Partly due to the cost of transportation, and partly due to national concerns about relying on foreign suppliers, the electricity grids of different countries were not well linked. Power did flow between the countries, but there were significant bottle necks – for example, between the UK and Europe, and between Italy and France and between France and Spain.

Historically, most power and gas utilities were either government owned or highly regulated monopolies. However, a wave of privatisation, competition and deregulation – starting in the UK in the 1980s and 90s – had led to a varied industry landscape.

In Germany, a few large privately owned and lightly regulated power generators and gas pipeline companies sold their product into a large number of largely municipally owned distribution companies that were local monopolies.

A similar situation was common in the Nordic regions and, to an extent, in Spain and Italy – although some of the power generators in these countries were government owned (even some of the German power generators, such as RWE, had significant government ownership). Thus, in much of Europe, the power and gas businesses were still considered strategic industries by governments, with heavy state involvement. They were able to argue for a monopolistic or oligopolistic status in return for keeping the lights and heating on.

In the UK, the government had initially pushed for more of a competitive market. Back in the 1990s, the two major power generators had enjoyed very high profits, and had been forced to sell off assets. Many new players had entered – causing prices to crash. The resulting bankruptcies resulted in generators being bought up by large and typically foreign power companies such as E.ON and RWE (both German), EdF (France), and Iberdrola (Spain). Centrica (the downstream part of the former British gas monopoly) and Scottish and Southern were two UK players who survived all the consolidation. These acquisitions were formed into about six large and vertically integrated companies, who competed in power generation and retail, with the power and gas grids being regulated, and often owned by infrastructure companies. The power companies had all entered the gas business – which had deregulated prior to the electricity business. However, Centrica still had a significant share of the gas market as well as a growing presence in electricity. The government vacillated between allowing the industry to earn adequate returns (to secure investment in energy infrastructure) and blaming them for “fuel poverty”.

In France, the government owned monopolies of EdF and GdF remained largely untouched. EdF was unusual in its heavy reliance on nuclear plants – which were expensive to build but had very low variable costs.

Central Europe was still cowboy country – with a mish mash of monopoly and regional power companies – some vertically integrated and some not. Regulators were fickle and profitability could rapidly swing from positive to negative.

The US acquisition was one of the first made – at a time when the US market was beginning to deregulate. However, after a series of problems such as the bankruptcy of Enron the US had stopped deregulating its markets and E.ON retained a strong business in Louisville Kentucky that served its local state markets as a regulated monopoly. The utility was well run and had avoided any of the problems characteristic of some of the US utilities. Returns were stable but low due to state regulation which focused on keeping prices for consumers down.

The gas industry was somewhat different to the power market. Few European countries produced enough gas for their own demands. Because gas could be transported further than electricity (which was expensive to move more than about 500-1000km), the European gas business tended to consist of bigger companies, able to negotiate with distant suppliers in Norway, Russia and North Africa (who supplied gas by pipeline) and more distant providers from Trinidad, Nigeria or the Middle East who liquefied the gas and sent it over in huge refrigerated ships to be re-gasified in European ports.

Thus, there was a single strong national gas competitor in most countries, with supply contracts from a mix of different providers.

There was more growth potential in gas than electricity, as not all homes and businesses received gas, and gas was seen as a lower carbon alternative fuel to coal for use in power generation. However, to date, high and volatile prices for gas had resulted in a more limited expansion of gas fired power plants than had been expected – except in a few markets such as the UK and Spain.

Overall, while power generation markets were, broadly speaking, national in scope – gas markets tended to cover several countries e.g., “Central Europe” or “North Sea”.

Origins

E.ON was formed from the German conglomerate, VEBA, which decided to focus on its German power generation businesses, Preussen Electra – divesting a host of other businesses. Following a merger with the Bavarian utility, Bayernwerk, E.ON was formed – headquartered in Duesseldorf but retaining a second headquarters, for the German business, in Munich.

E.ON did not stand still. It quickly acquired electric utilities in the UK, Sweden and the US. It hired a former Shell executive, Mr Bernodaht, as CEO - who set about transforming E.ON into the strongest European power and gas company.

E.ON's most successful acquisition was Ruhrgas, which imported gas from Russia through a series of pipelines that cross Eastern Europe before entering Germany. This deal was completed shortly before gas prices started to rise, and Ruhrgas became highly profitable. Because Ruhrgas controlled most of the gas coming in from Russia and Norway, and because this was the main source of gas for Germany, it enjoyed a high price – higher than those in neighbouring markets.

Although E.ON's vision was to create an integrated power and gas company, Ruhrgas retained its headquarters at Essen. Ruhrgas had relatively few employees, as its main activity was writing contracts between suppliers (predominantly Russia) and customers (predominantly large German companies or municipalities). Its employees understandably regarded themselves as an elite, and relations with other E.ON employees could be abrasive.

However, some heavy clouds were gathering on Ruhrgas' horizon. The German gas market was being opened up for competition. Many of Ruhrgas' contracts were up for renegotiation. New supplies of LNG were becoming available. The result was that Ruhrgas would face significant competition in the form of lower price gas imports, which could turn its exclusive contracts from Russia into a liability rather than an asset.

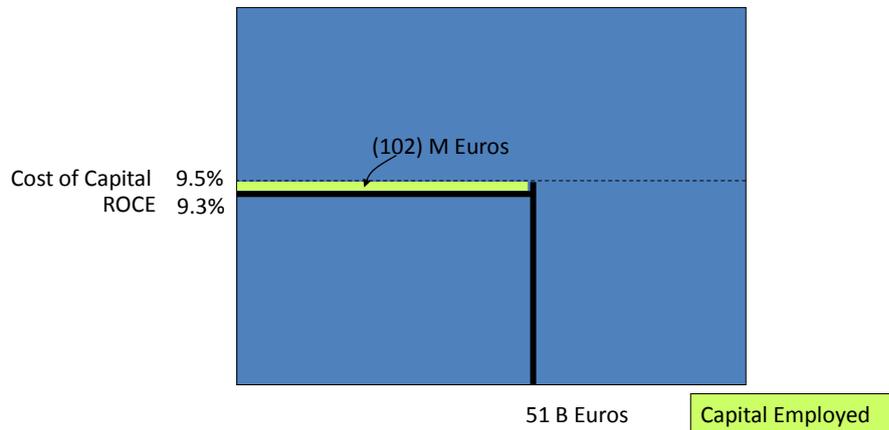
There were also clouds gathering for some of E.ON's other core businesses, such as nuclear. The German public was the most anti-nuclear in all of Europe and E.ON's plants would have to be retired under current Germany law – although many industry commentators thought that nuclear plants might be allowed to keep operating (as nuclear plants emit no CO₂). There was also pressure on the fossil fuel plants (gas and coal), which might face increased costs in the future related to CO₂ emissions.

Partly to address these threats, E.ON continued to expand. It acquired a number of businesses in central Europe – primarily in Bulgaria and Romania. These businesses consisted largely of “downstream” regulated distribution and retail businesses – E.ON had been unsuccessful in acquiring power generation assets in these markets, but hoped to do so in the future. The acquired businesses were typically relatively small players in their domestic markets.

Acquisitions required paying significant premiums and, to maintain returns to shareholders, E.ON was continually working to reduce costs. To do this, E.ON let each acquired business have significant autonomy. In practice, this meant that each country was a business unit with its own management team. The management of each unit was set performance targets based on what was required for the company to deliver an adequate performance to sustain the stock price.

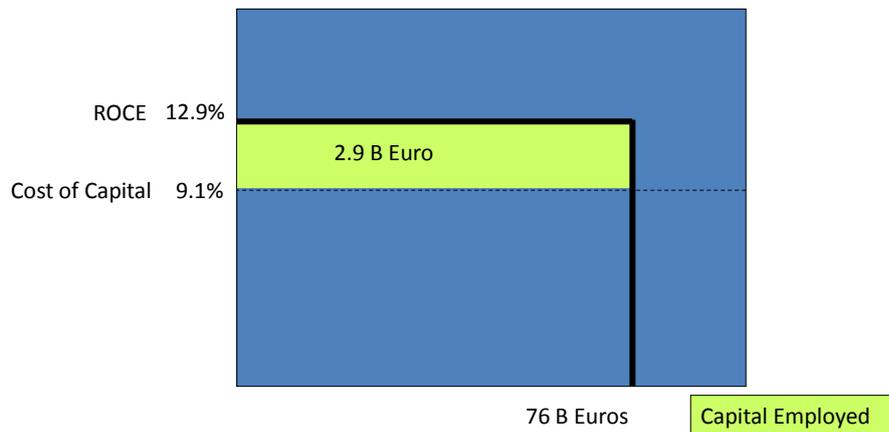
While some observers commented that the company still had a lot of potential to reduce costs further, costs came down enough to keep return on capital employed on an upward trend – as illustrated by the following exhibits for the development of Economic value added between 2002 and 2008:

E.ON 2002



Source: E.ON Annual report. Note ROCE = Return on Capital Employed

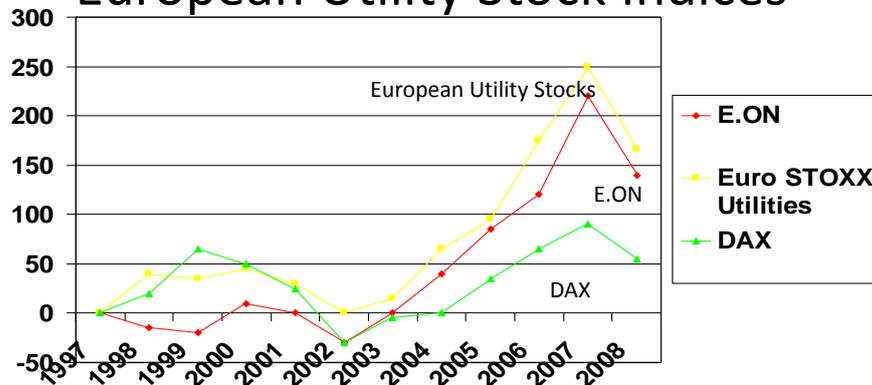
E.ON 2008



Source: E.ON Annual report

The cost reduction was not the only reason for improved performance. German power and gas prices had risen, also contributing to healthier profits. This performance had kept shareholder returns at an adequate level – while also growing the company rapidly:

E.ON Ten-year Stock Development versus German and European Utility Stock Indices



Source: E.ON Annual report

In 2006 E.ON made a significant decision to invest heavily in renewable energy. Prior to this time the history and culture of the company, which was steeped in fossil and nuclear power, had led to a strong resistance to renewable energies. But the Board was convinced that the market offered too significant a long term prospect to be ignored. A dynamic executive from BP, Frank Mastieux was hired and allocated significant capital to acquire investments in wind energy in particular.

Wind power sites were normally developed by relatively small developers, who were often willing to sell out to large companies at an attractive profit. E.ON saw an opportunity to build a position by such acquisitions – and set its targets on trying to close the gap with other utilities such as Iberdrola who had already made major investments in wind power in particular. However, profitability in renewables was not high – because the assets typically had to be bought from developers, who could auction them to highest bidder. Even if E.ON sought to develop projects itself, the initial investments tended to be very capital intensive, depressing returns on capital in the early years of the project.

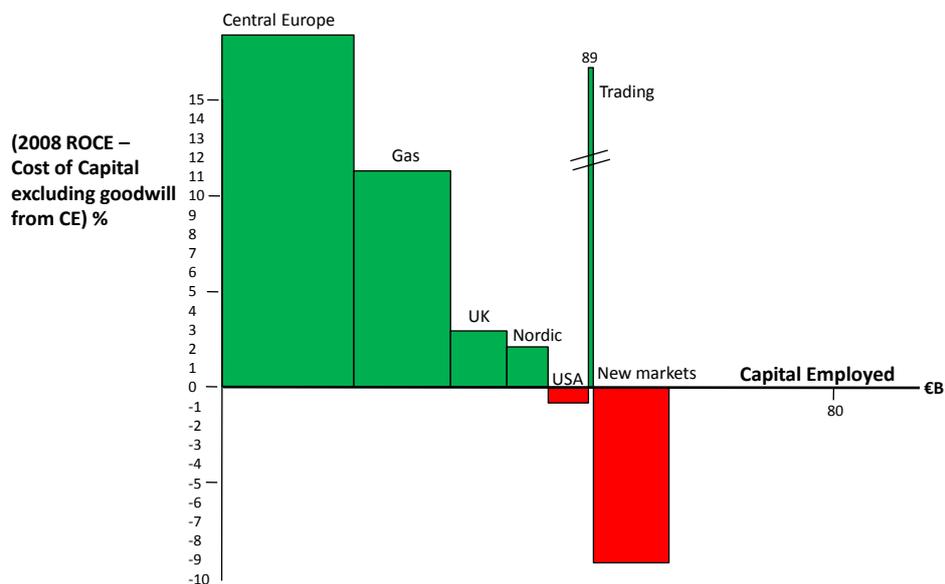
In 2007 E.ON launched a bid for Endesa, the large state owned Spanish utility that had recently been privatised. E.ON's performance had been strong, leaving it with a lot of cash and a strong balance sheet, and this large deal would enable it to continue to develop its strategy based on the idea of the "European copperplate" – an integrated, European-wide power generation and trading business. Unfortunately, the Spanish government did not like the idea of a takeover by a large German company, and was glad when the Italian state owned electric utility, Enel, stepped in as a white knight. E.ON was allowed to purchase some Spanish, French and Italian generation plants as compensation – but these did not create the type of strong business that E.ON preferred.

At the same time, E.ON also made a risky investment in some Russian generation assets. Regulated prices were low and E.ON was required to invest a large amount of capital in renovating the plants – so the initial returns were low. However, the Russian government had committed to allowing prices, and thus returns, to rise.

In 2008 E.ON's Executive Board met to review the corporate portfolio. On the plus side, E.ON had grown to be one of the largest, and the most European of power and gas

companies. It had grown while still meeting (even if not exceeding) shareholders expectations. It had acquired a crown jewel in Ruhrgas. A few other companies were larger, such as EdF, but they were concentrated more in their home market.

On the minus side, most of the businesses outside of Germany had not yet established strong positions. The highest returns still came from Germany and particularly from Ruhrgas and the nuclear plants whose assets were heavily written down (trading also made good profits – but was a relatively small activity):

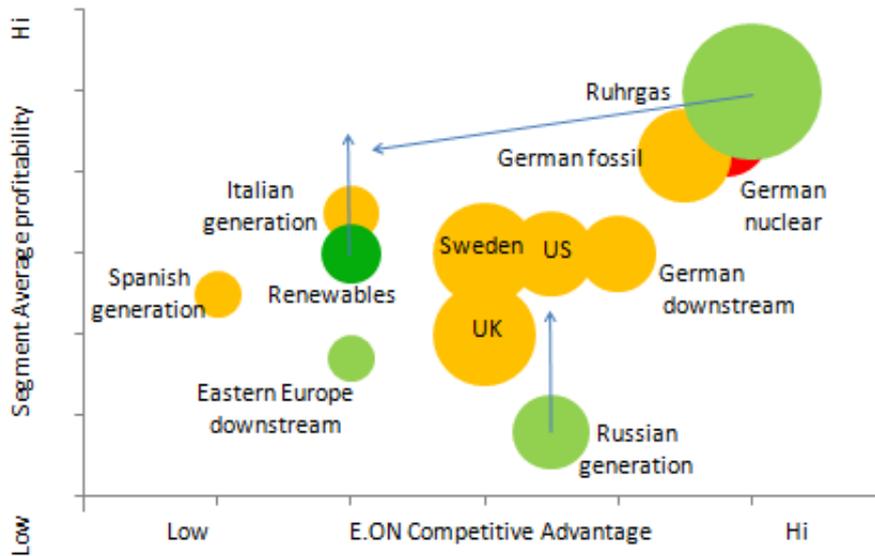


Note: Central Europe is primarily Germany. Gas is primarily Ruhrgas. New markets is primarily Russia, Spain, Italy, France and Renewables.

Strategic Review

The board had asked the strategy department to develop a strategic analysis of the current position and had been presented with the following summary chart. The position of the bubble indicated the strategy department's view of industry segment profitability, and the competitive position of the business. The size of the bubble indicates the net assets invested and the colour the growth rate (Red, Amber, slightly green and vivid green). Arrows indicate the expected trends.

E.ON Portfolio 2008



Note: Bubble area proportional to book value excluding goodwill

Questions:

1. Review the positioning of the bubbles on the chart. As a board member, would you question any of them?
2. What is your diagnosis of E.ON's position?
3. What overall goals and strategies does this matrix suggest?
4. What factors, other than those in the matrix, might you want to consider? What strategies would that imply?