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Minority rule

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Anyone looking for a chess game in the recent merger of Florida Power and Light (FPL) and Entergy may be disappointed. But while the combined company's strategy may be straightforward, given the framework of the Florida power market, synergies may be less apparent.

While FPL, which profits from state-granted franchise monopolies, sees no reason why merchant plants should be allowed to operate in the Sunshine State, the company wants no such constraints around its activities elsewhere. In August, FPL agreed to buy New Orleans-based Entergy Corp in a deal valued at $27 billion, based on its $16.4 billion in stock-market capitalisation and $10.7 billion in debt and preferred stock. The combined company would become the US's largest utility, with over 6.3 million customers.

The merger is a stock-for-stock transaction. Each holder of FPL Group common stock will receive one share of the new holding company. Each holder of Entergy common stock will receive 0.585 of a share of the new holding company. The two companies have authorised share repurchase programmes totalling $1 billion to be implemented prior to the close of the merger. The programmes ? $570 million at FPL and $430 million at Entergy ? include remaining authorisations from existing share repurchase programmes.

Cost savings estimates of between $110 million and $150 million from the regulated businesses of the merger partners are expected to be derived from elimination of duplicate corporate and administrative functions and procurement economies. Deregulated businesses are expected to provide annual cost savings and revenue enhancements totalling between $40 million and $125 million. Additionally, the competitive businesses are expected to account for annual capital expenditure savings of $50 million to $100 million.

The new entity ? as yet unnamed ? is expected to boost its merchant plant operations. But not in Florida ? at least not yet. FPL operates merchant plants in 13 states outside Florida. Entergy also operates four merchant plants throughout the US and is said to have ordered about $2 billion in turbines from GE for upcoming merchant plant projects. That is almost the end of the story. But not quite. While both partners consider merchant power markets as part of key components of a growth strategy, it is in peripheral businesses where the real synergies lie.

Synergies cited

A source at Entergy says, ?It turns out that the original synergies touted in the merger announcement on July 31 remain the primary motives for the merger: outstanding nuclear power programmes, international merchant power programs, etc. Merging as a strategy simply to put power into Florida isn't a very likely scenario.?

Speculation in some circles was that the merger was precipitated by the expected rescinding of Florida's merchant plant taboo, or that Entergy's operations would be used by FPL to funnel power into the existing Florida retail market that the company dominates. However, engineers maintain that such a proposal is technologically unlikely, given the location and nature of Entergy's operations.

Moody's Analyst Tucker Hackett says ?Entergy would love to get into Florida ? just like everyone else. It's a dynamic market. But serving that market is not an objective of the merger.? The objective of the merger is an extension of the Entergy-Koch Industries business, that is the unregulated wholesale energy power marketing and trading business, according to Hackett.

In late April, Entergy and privately held Koch Industries announced plans to form Entergy-Koch LP, a new company that would be one of the leading energy companies in North America and Europe. The combined entity will deliver, market and trade power, natural gas and other energy-related commodities, including weather derivatives, through wholly owned subsidiaries, including a pipeline company, which will operate the interstate natural gas pipeline system now called Koch Gateway. Entergy-Koch will be among the nation's top ten energy commodity traders, in terms of combined volumes of electricity and natural gas traded. The new company will have total assets of approximately $1 billion, including the 10,000-mile Koch Gateway Pipeline, one of the largest natural gas transmission systems in the Gulf South, and the Bisteneau gas storage facility.

Koch Industries also will contribute the capabilities of its affiliate Koch Energy Trading, which markets and trades gas, power and weather derivatives. Entergy will contribute to the venture its power marketing and trading businesses ? consisting of Entergy Power Marketing Corporation in the United States, and Entergy Trading and Marketing in Europe ? and also cash. Entergy estimates this cash contribution at approximately $350 million, $150 million of which would be funded with equity and $200 million with debt.

Tapping Wall Street

Bob Bellemare, vice-president of Albuquerque-based energy consultancy RCI, concurs with the Moody's analyst that unregulated business sectors are important for even a cash-flush energy company the size of the combined FPL-Entergy. ?The trend is for energy companies to go to the capital markets to raise cash for unregulated businesses, such as telecoms, internet and home security.? Bellemare noted unregulated businesses are the primary source of revenues for many large energy companies, and that many of these businesses are eventually spun-off, generating windfall profits through divestiture.

That assertion is borne out by 2Q financials from Duke Energy ? another would-be player in the Florida merchant plant sector. Duke derived 85% of revenues from unregulated businesses, including energy trading, North American merchant plants, and ancillary businesses, such as power plant construction and engineering services. Unregulated businesses also accounted for about 43% of earnings for the quarter. At the same time, the company will make an initial public offering of Duke Energy Field Services. That 26.3 million share IPO, valued at about $550 million, was slated for May but was pulled back pending improved market conditions. Mandated as co-leads were Morgan Stanley and Merrill Lynch.

Analysts also have speculated that Duke will spin-off its merchant power plants. However, Duke officials assert that if divestiture of merchant plants is put into motion, it won't happen until the power markets in North and South Carolina are deregulated.

The beat goes on

The merchant plant issue still is being played out in Florida, with Duke as a major force in the move to deregulate that sector. Other major energy providers are salivating at the prospect of moving into the Florida market where there indisputably is a need for additional capacity, fuelled by frequent weather peaks and an influx of companies moving into the state. ?The merger has not changed our strategy. FPL continues to add generation. We continue to stress that Florida needs a mix of combined and simple cycle plants to solve the problem of slim margins of excess capacity,? according to Duke Vice President Rick Rhodes.

In early March 1999, the Florida Public Service Commission (PUC) approved plans by Duke Energy Power Services and the Utilities Commission of New Smyrna Beach (UCNSB) to build the state's first merchant power plant. Plans called for the 514MW plant to provide 30MW of electricity to the UCNSB for resale to its more than 20,000 customers, with an option for an additional 40MW. The balance was to be marketed to other investor- and municipally-owned utilities and electric cooperatives on the open wholesale market. A coalition comprised of Florida's existing electric utilities challenged the ruling, sending it to the Florida Supreme Court. The court sided with the challengers in maintaining that the commission lacked the authority to approve the merger which runs counter to Florida state law. But the court ruled that no final decision be made until after the case was reheard.

The rehearing in the Florida Supreme Court on the merchant plant issue is a white-knuckler. On May 5, the Florida Public Service Commission (PUC) sought to have the court look again at its preliminary rejection of the New Smyrna project. ?Rehearing is a part of the normal process of appellate review. An important part of the process is that you are not supposed to file to have a case reheard except based on an important point of law ? that the court has misapprehended or overlooked facts,? according to PUC attorney Richard Bellak. The PUC attorney said the agency is optimistic because the court has not issued a ruling in the four months since the rehearing. The only issue the court is ruling on is whether the commission's ruling should be reversed or upheld, said Bellak. However, no matter how the court rules, parties on both sides of the issue are expected to use the outcome as precedent to bolster their respective positions.

Duke's Rhodes, says the company was surprised by the court's ruling against the New Smyrna Beach project. In addition to asking the court to review the facts in the the New Smyrna proceeding, Duke hopes to learn from what the court deems to be the most germane issues prior to lobbying to have the ban on merchant facilities in Florida overturned by the state legislature. In the meantime, Duke is seeking interim approval from the governor's Energy 2020 study commission before the legislature comes back in session in March. That commission is composed of proponents of power deregulation, and contains no representatives of utilities. The commission has been charged with producing a report on deregulation by December 1, 2001.

Ronald Vaden, director of the Utilities Commission of New Smyrna Beach, says, ?The lights have been barely on all summer throughout Florida because there is no new generation. Industry has recently looked to Florida to relocate because of its cheap power. In fact, when Duke announced that they were putting in the New Smyrna plant, we received close to 20 calls from companies interested in moving here. Since the court ruled against the project, those calls have dried up.

?Florida is a hot market. But there are a lot of other hot markets where legality of merchant plants is not an issue. FPL is doing a good job of keeping other companies out of the market. They are not hurting for money to do it ? they have almost unlimited funds. There is a four-year backlog at General Electric for 500MW turbines. If they delay deregulating this market much longer, companies will deploy those turbines elsewhere where they can make money. Then the economics of the whole state will suffer as the price of the little available power rises.?

In fact, faced with an estimated $518 million increase in costs tied to oil and natural gas to operate its power plants, FPL is expected to ask Florida regulators to approve rate increases effective in January to recover those costs. FPL officials maintain that rate increases are justified as the cost of oil used to generate electricity has more than doubled since the first quarter of 1999 and has not been this high since the Gulf War in 1990. Since January 2000, oil prices have increased 44% per barrel. Natural gas prices also have risen unabated, climbing 77% since January 2000. With the onset of winter, natural gas prices may increase further as demand for heating fuel increases, according to FPL officials.

The FPL-Entergy combination has received the blessing of ratings agency Fitch IBCA. A recent Fitch report maintains that the merger is a good move as it combines two companies with similar business strategies, which includes continued strong core utility operations and targeted growth in wholesale energy markets, primarily in clean, low-cost generation. The ratings agency notes that this narrowly focused unregulated business strategy leverages the companies' core competencies in gas-fired generation and nuclear operations. The new company plans to continue to expand its nuclear presence and construct new gas-fired generation facilities ? 76 gas turbines under contract through 2005 ? in key domestic regions. FPL-Entergy should also realise revenue enhancements through its expected marketing and trading joint venture with Koch Industries (Entergy-Koch LP) as well as telecommunication opportunities in Florida and Entergy's respective service territories. Positively, the combined entity should generate strong free cash flow ? net dividend and utilities' expenditures ? over the initial three years of approximately $5 billion, which should help fund the projected growth of the unregulated businesses.