Electric Avenue

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Of all the US energy companies eager to exploit the rapidly-deregulating European power generation markets, TXU Europe has been one of the most successful. Having established a firm base in the UK with the buy-out of Eastern Energy, the company has quickly expanded ? most successfully into Scandinavia. But its sights are now firmly set on mainland Europe, and the huge potential that its growing electricity markets represent.

TXU Europe hit the project finance headlines last year with its breakthrough deal for the Norwegian hydroelectric power utility Svartisen. The NKr978.9 million ($114.2 million) financing part-funded the 30% acquisition of power extraction rights from the plant ? which has the lowest generation costs in Europe. The Svartisen turbine is the largest in Norway and the station is extremely flexible, enabling generation to be limited to the winter months when prices are highest. The reservoir itself holds 4.5 TWH of water ? 6% of the country's total stored water ? and generates 2TWH of Norway's 110TWH per annum.

The Svartisen deal, which was closed in October 1999 and won Project Finance's European Power Project Bond Deal of the Year award, was arranged by Chase Manhattan and is the first hydro-power bond financing (see Project Finance February 2000 page 49). The tenor was pushed to 30 years and the bond was monoline wrapped by MBIA-AMBAC.

One of the key factors in the Eastern Norge Svartisen deal was the complex nature of Norway's ownership legislation. The country has strict ownership and quasi ownership rules in order to protect power generation assets ? which it considers to be of national importance.

Ownership of power generation assets ? all of which are hydroelectric ? must be at least two-thirds public. The remaining third can be put up for sale at which anyone is entitled to bid. Many of these assets remain in the hands of Norwegian municipalities ? a number of which are now in the process of selling the permitted 30% holding to the private sector. The government has, however, kept tight control over the process by stipulating that in order to own power generating assets, you must have a licence. Thus, while anyone is free to bid on such deals, their application for a licence can be blocked if the government feels that they are for any reason unsuitable. This law, which was originally passed in 1917, was amended in June 1999 to provide further protection to the nation's hydro assets.

Hunt at TXU believes that this legislation was instrumental in putting off a large number of bidders for the Eastern Norge Svartisen deal. ?Many people simply backed away from the transaction, seeing it as too risky,? he says. The project began in 1977 with design of the power station by Statkraft, but building did not commence until 1987. By law, Statkraft had to offer 30% ownership of the plant to the local municipality ? Nordland County Council (NCC). This ownership was offered in perpetuity and the price was agreed through negotiation and input from expert witnesses in an arbitration procedure. NCC's rights to acquire the 30% holding had to be exercised by 23 April 1998.

The resultant price (which remains confidential) was that sought by NCC in soliciting bids for the plant. However, while NCC owns the plant in perpetuity, it was offering the 30% stake for a defined period of 50 to 60 years. ?This was a grey area,? explains Hunt. ?TXU has the right to extract power from an asset it doesn't own. NCC is essentially leasing the asset for a term of 50 to 60 years.?

This issue of economic ownership proved extremely contentious and led to a change in Norwegian legislation to prevent the situation occurring again. The Norwegian government's sensitivity to the ownership of power generation assets led to several politicians claiming that although the successful bidder would have economic ownership of (30% of) the asset, in this case economic ownership was, in reality, physical ownership. The issue was debated throughout the summer of 1998 until the minister responsible, Marit Arnstad, agreed the deal.

The contentious nature of the deal meant that TXU Europe had a pretty clear run at it. Other Nordic companies showed interest but foreign bidders were significant by their absence. Hunt believes that TXU Europe was confident going forward with the deal where others weren't largely because they took more legal advice. The plant was extremely attractive to the company for a number of reasons, not least the importance that the Nordic region plays in TXU Europe's plans throughout the region.

TXU Europe's Nordic business represents a small but growing share of its European activity. It is initially surprising that the company should focus on Norway, Sweden and Finland (countries with populations of 5 million, 8 million and 5 million respectively) even though Norway's energy consumption per capita is the highest in the world at 30,000kw/hours per anuum. But TXU Europe now has a 130MW generating capacity in Norway through Svartisen and Kobbelv and has a 50/50 retail and trading venture with Lund Energi in Sweden. In Finland the company owns 15% of PVO ? the country's second largest generator ? and has access to 580MW of fossil fuel stations. It also operates TSM, a wholesale trading company, through TXU Nordic Energy, which is held 81% by TXU and 19% by PVO. But the real jewel in this region's crown is Nordpool, which Hunt describes as ?a wonderful marketplace. It is the most developed market in Europe.? Nordpool is a cleared market and has over 300 trading entites. It is very liquid and very transparent. Nordpool was set up in 1993 in Norway with Sweden joining in 1996 and Finland in 1998. Denmark is expected to join soon.

?The opportunities appeared in Scandinavia before they did anywhere else,? explains Hunt. ?Nordpool is far more mature than other European markets ? the UK pool is now taking advice from Nordpool. Our Nordic experience has a lot to teach the rest of TXU Europe.?

The TXU strategy has been to expand in Europe through alliances with second tier players and the company wants to have a presence across the whole value chain from production to retail. Finance director of TXU Europe Paul Marsh says that TXU's US strategy of having upstream assets and contracts it puts the company in a much better position to manage price volatility and fluctuations in demand. This is what it will be planning to replicate throughout Europe.

But while TXU Europe has big plans for the rest of the region, its business is still very much concentrated in the UK. This business ? which accounts for 70% of TXU's European activity ? grew 16% in 1999 and there is little sign of the pace slowing this year. UK power and distribution are run through wholly-owned subsidiary Eastern Electricity, which now plans to set up a new 50/50 joint venture company with London Electricity. The latter is owned by Electricite de France (EDF) and has 2 million customers in the capital.

?The key driver behind any joint venture of this kind is that the two parties operate in regions with common physical boundaries,? says Hunt. While London Electricity is thus the only real candidate for a joint venture, the operational benefits of the move made sense. The two will merge their network asset management and operation activities and the resultant operator will be the first to offer utility network asset management and operating services in the UK. The deal was passed by the European Commission in February.

OFGEM, the government regulator, set out the conditions for the merger at the end of March. Callum McCarthy, OFGEM's director general, stated that ?...OFGEM will not act to inhibit these combinations on the basis that there are benefits and returns to customers in the form of a rebate of no less than £12.5 billion and a greater quality of service.?

Many UK power generators may be having more to do with OFGEM this year than they would like. The industry has been enveloped in a row between generators and the government over the new Competition Act that was due to come into effect in March. OFGEM wants to impose a so-called ?Good Behaviour Clause? on power generators, which enables it to impose harsh and unnegotiable fines on companies that it believes to be abusing their position of market dominance or acting as a cartel. These fines can run to 30% of turnover.

The proposal was announced in mid-February and TXU Europe was one of only two generators ? the other being Magnox ? to agree to it. Five other companies took the view that they would take their chances with being referred to the Competition Commission and refused to consent to the proposal. They were Powergen, National Power, British Energy, Edison Mission Energy and AES. ?No licence condition can give you 100% comfort,? explains Ian Benfield, TXU Europe's portfolio development manager, who was closely involved in talks with OFGEM at the time. ?We had several useful meetings with OFGEM and we felt that there was good degree of trust between us.? Benfield explains that there is often a degree of ambiguity in operating licences and it is something that companies have to live with. ?We have to persude OFGEM that what we are doing is reasonable. But we felt that they had a good understanding of our situation.?

Clearly, TXU's belief that they were better off playing ball with the regulator than throwing themselves on the mercy of the Competition Commission was not shared by most of its competitors. But there are signs that others may be coming round to their way of thinking. On March 22, Edison Mission Energy announced that it had decided to accept the good behaviour clause. (National Power has since followed suit.) It remains to be seen whether any more of the renegade five will follow suit, but it is clear that those at TXU Europe believe that their chances of persuading the Competition Commission that the clause is unfair remain slim.

Given its success with Eastern in the UK, TXU Europe is now actively looking to roll out its UK model across Europe. But things have not been running as smoothly as planned. The company has been eager to get into Germany, but so far talks have come to nothing. ?The concept is to try to develop a pan-European asset and trading portfolio,? explains Hunt. ?Just by its size and weight Germany is critical to this process.? TXU Europe had been in talks with German utility VEW Energie, but these were abandoned when the tie up between German mega-utilities Veba and Viag was announced.

The Iberian peninsular is also a prime target for TXU Europe ? which already has a larger physical presence there than it does in Germany. Spain is the fastest growing electricity market in Europe. When Project Finance spoke to Hunt in early March, TXU had made an unsolicited bid for Spanish electricity supplier Hidroelectrica del Cantabrico. The company already owns 5% of Cantabrico (which is responsible for 7.3% of Spain's electricity supply) and this would have been its largest acquisition in Europe since Eastern. TXU Europe offered Euros 21.25 cash per share, valuing the company at $2.3 billion.

Hunt adds: ?There is always considerable competition for prime strategic assets throughout the European market and this is often reflected in the price.? Therefore, when domestic utility Union Electrica Fenosa topped TXU's bid by 13% later in the month, TXU declined to enter a bidding war. The move is, however, a blow for TXU, and runs contrary to the Spanish government's stated desire for a number of players in the market to ensure competition. Fenosa's acquisition of Cantabrico reduces the number of electricity generators in Spain from four to three (the other two being Iberdrola and Endesa), and gives Fenosa more than 20% of the market.

Its Spanish experience will serve as a salutory lesson for TXU in its drive for expansion across the region. Many electricity generating markets in Europe are still in an evolutionary stage of development and are suspicious of foreign involvement. Certainly in Cantabrico's case, key shareholders and the regional governments of Asturias and Galicia (where Cantabrico and Fenosa are headquartered) were anxious to keep the company in Spanish hands.