Big continues to be “the message” in electric and gas utility mergers and acquisitions, with mega-deals involving Exelon-Constellation Energy, Duke Energy-Progress Energy, and NSTAR-NU recently closed.

Oliver Wyman believes that M&A opportunities with smaller utilities could be equally attractive to investors pursuing well executed growth strategies. A small-acquisition growth strategy could be of value for private equity and infrastructure funds as well as for publicly traded utilities.

— Gerry Yurkevicz

1 Our title references the well-known book by the British economist E.F. Schumacher, Small is Beautiful: Economics As if People Mattered. Our context is that “bigger is not often better” when thinking about utility mergers and acquisitions. There can be plenty of opportunity on the small side.
THE SMALL-UTILITY OPPORTUNITY

Of course, “small utilities” is a term of art. For this article, we defined small gas utilities as having less than 150,000 customers or $500 million of net utility property, plant, and equipment (PPE), a good proxy for the rate base. We categorized small electric utilities as having less than 250,000 customers or less than $1.5 billion of net PPE.

With these definitions in mind, the small-utility opportunity actually turns out to be quite big: Small-utility net PPE totals more than $30 billion and annual after-tax earnings potential exceeds $1.3 billion.

- As shown in Exhibit 1, the small-utility opportunity includes over 150 electric and gas utilities spread across the United States.
- There are relatively more opportunities in the gas utility segment as opposed to electric. Our research suggests that more than half of small acquisition opportunities are gas utilities.
- Most of the opportunities are smaller operating companies of multi-state mega-utilities, but potential targets also include small-cap and private utilities.

EXHIBIT 1: SMALL GAS AND ELECTRIC UTILITIES BY CENSUS REGION
Number of Utilities Segmented by Customer Size (Electric <250,000; Gas <150,000)

Source: SNL, Oliver Wyman Utility M&A Analytical Engine.

Additional acquisition opportunities for small public electric, gas, and water utilities will be the subject of a separate article.
Overall, utilities can be an excellent vehicle for putting investor capital to work, especially private equity, where the investor commitment overhang currently totals almost $500 billion:

- **Utilities** are an attractive infrastructure market, with a solid and large customer-ratepayer base, low earnings risk, solid cash flow, and financeable capital spending.
- Though not as “hot” as other energy infrastructure opportunities (e.g., pipeline investments to bring shale natural gas to market), utilities offer solid high-single digit or low double-digit equity returns, which may be enhanced through back-leverage.
- Utilities make an excellent, lower-risk component of a well-diversified energy infrastructure portfolio.

On top of this, smaller utilities offer attractive upside for investors:

- Many smaller utilities, especially small divisions of mega-utilities, may suffer from poor customer experience management and poor regulatory relations. Smaller operating divisions typically represent a tiny portion of a major utility’s customers, assets, and earnings. But these small divisions often take as much, if not more, management time as larger operations.

State commissions and government officials overseeing these smaller operating companies are crying out for: 1) better focus on a particular state’s customers, 2) local utility management, 3) local regulatory relations, and 4) a return of local jobs that typically have been lost through attempts at consolidation and standardization. A renewed focus on local customers and regulators can yield rich results: Our research suggests that utilities that focus locally, first on the customer and then the regulator, can capture an incremental 1-2 percentage point increase in long-term ROE.

- Smaller utilities can put more investor dollars to work, as they often suffer from under-investment, which in turn leads to lower earnings growth (about 2 percentage points annually or 30 percent less annual net PPE growth than large utilities—see Exhibit 2). It is much easier for large utilities to focus on investment in their bigger core operations. Over a 10-year period, closing this investment gap could yield a 20 percent or $500 million annual increase in after-tax earnings among smaller utilities.

**EXHIBIT 2: SMALL VERSUS LARGE UTILITIES: ANNUAL NET PPE CHANGE, 2006-2010**

<table>
<thead>
<tr>
<th>Year %</th>
<th>Large Utilities</th>
<th>Small Utilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>6.7%</td>
<td>4.7%</td>
</tr>
<tr>
<td>2007</td>
<td>6.0%</td>
<td>4.0%</td>
</tr>
<tr>
<td>2008</td>
<td>5.7%</td>
<td>3.5%</td>
</tr>
<tr>
<td>2009</td>
<td>5.3%</td>
<td>3.0%</td>
</tr>
<tr>
<td>2010</td>
<td>4.9%</td>
<td>2.3%</td>
</tr>
</tbody>
</table>

**Source:** SNL, Oliver Wyman analysis.

**Note:** PPE = property, plant, and equipment.

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3 See Oliver Wyman’s 2011 article, *What’s Your Share of the $5 billion Prize: The Continuing Challenge to Keep Utility Customers, Regulators, and Shareholders Happy.*
• The risk of stranded investment is manageable with smaller utilities. In most parts of the United States, there are opportunities to start with a small utility as an initial platform and then develop a “roll-up” growth strategy, thus mitigating the risk that the earnings opportunity may not be “big” enough over a typical investment horizon.

Importantly, small utilities are not disadvantaged by their size. Recent research conducted by Oliver Wyman has shown that utility “economies of scale” are a mirage. Big acquisitions typically do not benefit the ratepayers of small operating companies: Rates are not lower and service reliability is no better due to being a tiny part of a big utility.

Small utilities may have slightly higher expense levels than larger utilities. However, small utilities manage their businesses well, experiencing expense growth rates and earning ROEs similar to those of larger utilities (Exhibits 3 and 4).

Strong management teams, tied to strong local customer and regulatory relationships, are key to executing a small-utility investment and growth strategy. Poor results have occurred when equity firms have embarked on a small-utility strategy but put in place the wrong management team, often with little or no connection to local customer groups, politicians, or community.

EXHIBIT 3: SMALL VERSUS LARGE UTILITIES: ROE AND O&M EXPENSE, 2006-2010

ROE: average earned; O&M expense: annual % change

AVERAGE EARNED OR ANNUAL % CHANGE

9.0% 8.9% 4.6% 4.8%

Smaller and larger utilities have similar ROEs and expense growth rates

Source: SNL, Oliver Wyman analysis.
EXHIBIT 4: SMALL VERSUS LARGE UTILITIES: O&M EXPENSE PER CUSTOMER, 2006-2010

Source: SNL, Oliver Wyman analysis.

THE SMALL-UTILITY M&A ROADMAP: TEN STEPS

For private equity and other investor groups (e.g., pension funds, endowments), capitalizing on a growth strategy involves ten critical steps (Exhibit 5).

EXHIBIT 5: THE SMALL-UTILITY M&A ROADMAP: TEN STEPS TO THINK SMALL BUT GROW LARGE

The strategy starts with a four-step process for building the deal stream:

1. **Develop the small-utility strategy**: A successful business model built around small utilities requires a robust strategy. You cannot just react to the next deal that crosses your desk or participate in the next auction. A good strategy involves examining target markets, identifying near- and longer-term utility targets to build a significant enough business, understanding regulatory opportunities, developing an operating model, and of course, projecting financials.
2. **Develop business and find targets:** Oliver Wyman has found that business development aspects are critical to executing a small-utility growth strategy. You must understand the strategies and issues of potential sellers and their motivations; customer and ratepayer issues; and regulatory, political, and community issues and leverage points. Building relationships with both sellers and regulators is a key component and can help avoid the auction process that many mega-utilities and bankers typically utilize.

3. **Manage transaction costs:** It can be as costly in management time, legal and due diligence expenses, and banker's fees to do a small acquisition as it is to do a much larger one. A focused acquisition strategy and a small but capable dedicated business development team can be of great value in managing M&A development costs. A small-company acquisition strategy requires a focused plan and team, as transaction costs can otherwise easily spiral upward.

4. **Close the deal:** Of course, the terms and conditions matter a lot. But focusing on the regulatory approval process can yield enormous dividends. Creating and delivering "the story" effectively to regulators that know and trust you can speed up approvals and lay the groundwork for profitable growth and operations.

The next few steps in the roadmap involve all aspects of planning, as the business model, execution steps, and future integration plans all take on a higher level of importance when pursuing a small-company M&A strategy.

5. **Create a “buy small, think big” business model:** Buying small but thinking big requires a different mindset. It requires a vision of what is possible in the utility space in a specific market. It requires some degree of patience as you nurture and build relationships, as strategies of larger companies that contain targets evolve and change, and as opportunities present themselves (e.g., change of leadership at targets, poor regulatory results, once in a career outage or event that enables change).

6. **Develop a small-company business strategy and plan:** Acquisition planning can make or break the future. With a small utility or division spin-off or carve-out of a larger utility, you need to rethink business processes, people strategy, and systems needs. Thinking and acting like a small company is required: Small utilities do not need worldwide company complexity or systems. It is critical to translate vision and strategy into a great business plan, which then must be well communicated on a number of fronts—to investors, to the full management team, and to regulators and local stakeholders.

7. **Assemble the right utility management team:** A small-utility strategy requires that you make great choices on the core senior management team that will run and grow the business, especially senior customer, regulatory, operations, and business development managers. It takes about 5-10 key staff in core business activities to manage a small utility. Thinking small requires a fundamentally different approach than running a large or multi-state utility. Too often, we see investors pick big-company executives to run and grow small utilities; it usually doesn’t work. A tightly integrated cadre that works superbly well together is the recipe for success.
As Steps 8 and 9 indicate, deals and plans matter little unless you show results:

8. **Execute the plan:** Execution is what it is all about. A shared understanding between owners and management is required. The team needs to have the demonstrated ability to execute on the business plan. Big errors are magnified with small operations.

9. **Run the business:** Strategy breaks down for many investors when they stray from the path of providing superb customer service, developing strong local regulatory relations, operating and spending commensurate with a smaller scale, and creating local jobs.

Finally, buying one small utility usually is not the end game:

10. **Learn and grow the business:** Understanding and developing appropriate follow-on deals are critical next steps in making the small-utility strategy worthwhile to your investors. This business development effort will require patience and creativity. But once the first acquisition is up and running, it can function as a platform for building out the business.

## SMALL IS BEAUTIFUL—AND FOR EVERYONE

A number of companies are pursuing small-utility acquisition strategies. Recent examples include:

- Algonquin Power & Utilities has bought or is in the process of buying a number of small electric and gas utilities in California, the Midwest, and New Hampshire from larger utilities, including NV Energy, Atmos Energy, and National Grid.
- SteelRiver Infrastructure Partners, Alinda Capital Partners, and ArcLight Capital Partners all have pursued gas utility acquisition strategies as part of their investment portfolios.
- Sempra Energy, a large utility, recently agreed to purchase Willmut Gas, a small private utility, to further expand its relatively small gas utility footprint in the southeastern United States.
- Fortis, a large Canadian utility, announced it will acquire CH Energy, as part of an entry strategy into the US market.

This article was written in part for private equity and other investor groups that may be interested in infrastructure plays. But as evidenced by the examples above, larger investor-owned or private utilities can also embrace the “small is beautiful” mantra. There is no reason why a large utility cannot think small, following the ten steps as outlined above to grow. If you are big already, the “juice may not be worth the squeeze” in terms of overall earnings contribution in pursuing smaller acquisitions. If a large utility does choose to embark on this route, a change of mindset is usually required, away from big, consolidated, and centralized to small, local, and smartly decentralized.

As Oliver Wyman’s analysis indicates, a small-utility acquisition strategy could represent a multi-billion dollar opportunity. Energy-related investors would do well to consider whether such a strategy could help them meet their portfolio balance and growth goals.
ABOUT OLIVER WYMAN

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Oliver Wyman’s Energy team helps utilities and related energy companies address strategic and operational challenges through proven, results-oriented approaches. We have completed hundreds of engagements for more than 75 leading electric, gas, and water utilities across North America and Europe, creating sustainable shareholder value.

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