

## **Power Grid: Soft Landing or Hard? Firm Tests Strategy On 3 Views of Future --- Most Likely, Duke Energy Decides, Is a Growth Era Of 'Flawed Competition' --- Retailing Gas on the Internet**

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CHARLOTTE, N.C. -- When the stakes are high, engineers often take their designs to a wind tunnel, putting prototypes through a series of stress tests to see what happens.

At Duke Energy Corp., engineers-turned-executives are at work on what they call a "wind tunnel for testing strategy." They have taken the company's ambitious growth plans and tried to test them against various economic winds that might blow either in their favor or against them.

It's a timely exercise, amid rising fears that the longest economic boom in U.S. history is losing its force. "There are some big risks in the U.S. The United States is the only economy that hasn't gone through major upheaval in the past three or four years," says Richard Priory, Duke's chairman and chief executive. So the U.S. is the focus, even though the company is also pushing hard into Latin America, Australia and Europe.

As senior executives gathered for a two-day strategy meeting in Houston last week, they confronted three scenarios for the next few years, produced by Duke's strategy staffers. One, dubbed the Economic Treadmill, might have been called the Big Slowdown. It imagines U.S. economic growth slipping to 1% a year -- a difficult future for Duke because, with its aggressive buildup of power plants, it might have too much capacity amid weakening prices.

Then there is a Market.com scenario, where the Internet revolutionizes the buying and selling of electricity and natural gas, maybe giving buyers of energy a stronger hand against sellers.

Lastly, there's a scenario called Flawed Competition, which assumes continuing, uneven deregulation of the energy industry, lots of price volatility and a U.S. economic growth rate of 3% or more. For the moment, Duke executives say, Flawed Competition seems the most likely future, and it is the basis for Duke's bets.

The scenarios are just a part of what goes into the making of strategy at Duke, but they point to the large economic uncertainties facing every business in the summer of 2000.

Is the U.S. economy headed for a so-called soft landing or for a hard landing? Will interest rates keep rising? At Duke, with more than \$9 billion in debt on the balance sheet, every one-percentage-point rise in rates could reduce pretax income \$24 million this year.

Are energy prices peaking? And on a more profound level, there's this pervasive question: Is the Internet going to destroy my business?

At Duke, executives still see lots of unmet demand, especially for electric power. So they want to build. As the U.S. market deregulates, Duke is increasingly free to be an "energy merchant," a wholesaler in many regions of the country. It operates "merchant" plants from New England to California -- producing not just for a regulated local market, but also for the open market -- and it is building more in Mississippi, the Midwest and elsewhere. But is it all too much, especially if there's an economic slowdown?

"There is little doubt there will be overbuilding. It will happen," acknowledges James Donnell, president of Duke's Houston-based North American energy unit. "The question is, when?"

Duke's answer is not right away, and besides, it's willing to buy, build, sell and swap assets. For example, Duke recently sold off two chunks of a plant it was building in Texas even before completing it, because executives think the Texas electricity market may be glutted in years ahead. Where once Duke owned its generating facilities, mostly in the Carolinas, today it can build, buy and sell plants in many parts of the world.

And where once it sold its own power, largely at regulated prices, today Duke is a major trader and marketer of natural gas and electricity in the open markets, having gained such expertise through a 1997 merger with PanEnergy Corp. of Houston. Duke has a huge energy-trading operation and uses complex financial derivatives to hedge and manage positions. Of its \$22 billion in annual revenue, roughly 50% comes from trading and marketing activities.

So the strategy at Duke is, we're in the Flawed Competition scenario, volatility will be with us, and we're going to be traders. Thanks to prosperity and strong demand, price spikes in the summer heat will probably be around for years to come. Imbalances in supply and demand will persist across regions. And smart traders can exploit these imbalances.

"If we get the cycles right, we're successful. If we get the cycles wrong, we're less successful or unsuccessful," says Mr. Priory, the CEO.

A number of economists, while outside the consensus, are scripting the Big Slowdown, or, in Duke-speak, the Economic Treadmill. Last month, for instance, UBS Warburg sent a bulletin to clients called "A Change in View: A Harder Landing in 2001" and saw U.S. growth slowing to 1.5% by next year's fourth quarter. John Makin of the American Enterprise Institute argues in a recent paper that "the enduring market belief in a soft landing makes a hard landing more likely, since interest rates don't rise enough and stock prices don't fall enough to slow demand growth."

Leonard Gatewood, Duke senior vice president for strategic planning, and his lieutenants are watching for 23 possible indicators of a Big Slowdown. So far they see only three. By contrast, 11 out of 20 signposts of the Flawed Competition scenario are registering, which is why Duke sees that as more likely.

For the Duke Energy strategists, the signposts range beyond macroeconomics to regulatory trends, technology, environmental issues, competitors' moves, and signals from Wall Street, such as patterns of consolidation in the industry. Still, what Duke calls "marketplace" signposts are vital. As one Duke document shows, 1999 real GDP growth of 4.1% was considered too strong to conform to either the Flawed Competition or Economic Treadmill view of how things are going. That growth rate fit only the Market.com scenario.

By contrast, the mismatch between insufficient merchant-power supply and continued strong demand was a clear signpost of Flawed Competition. The other two scenarios were looking for the opposite, i.e., more of a matchup between supply and demand.

Similarly, there's a signpost for regional price disparities. In Market.com and Economic Treadmill, these regional price differences should be small. So, these signposts don't appear. By contrast, the sharp regional variations coincide perfectly with the Flawed Competition view of the world.

One purpose behind scenario planning, which was pioneered by Royal Dutch/Shell before the oil crisis of the early 1970s, is to be prepared for the unexpected. So, what if things turn bad? In private conversations, some Duke officials are willing to put the Duke strategy through the wind tunnel of an economic slowdown. What they see is that in two regions where electricity supply and demand are roughly in balance, there probably would be excess capacity. One is the East Central power region, comprising some of the industrial heartland in Ohio, Kentucky and western Pennsylvania. The other is New England.

By and large, though, Duke doesn't see the Big Slowdown anytime soon, and isn't investing that way. "You want to be `long' electricity for at least the next two years," says Mr. Donnell.

That other scenario -- the Internet takes over the world -- stirs greater anxiety inside Duke. In such a case, the ownership of hard assets, such as generating plants, might be less valuable. Generating power could become a lower-value activity. More valuable would be "owning" direct access to the customers.

The indicators don't yet point to the Market.com scenario coming to pass. Only four of 23 signposts devised by Mr. Gatewood's planning staff have materialized so far. The Duke staff thinks it just saw another one, though. In May, Enron announced a bold venture to sell energy to retail customers, teaming with America Online Inc. and International Business Machines Corp. to form something called New Power Co.

Using AOL's subscriber base of 23 million and IBM's back-office billing and technology systems, Enron said it hoped to play the insurgent, selling electricity and gas at 10% to 30% below competitors' prices in states where deregulation has taken hold. A rollout in New Jersey and Pennsylvania is planned for later this year.

The Enron/AOL/IBM deal caught Duke's attention. Says Richard Osborne, whose job description at Duke is chief risk officer: "If you have a smart competitor like Enron, you look at everything they do and say, 'How does that affect me?' And sometimes, 'What are they seeing that we're not seeing?'"

If the Market.com or Internet scenario came to pass, being able to succeed at customer acquisition would become more important, especially via electronic commerce. Duke says it hasn't been caught flat-footed, since it created an e-commerce unit in 1999.

But Flawed Competition still strikes Duke as the most likely scenario, as evidenced by strong economic growth and tremendous volatility in energy markets -- both price spikes and regional pricing disparities.

The volatility has claimed some victims. When electricity prices spiked in the Midwest in 1998, Power Co. of America got squeezed and filed for bankruptcy-law protection. A Canadian natural-gas company got caught in a price squeeze last year, after which Duke bought a stake in it and replaced its top management. Numerous other utilities have tried trading as a new business, only to drop out.

"There's a tension. The marketplace is more volatile. At the same time, Wall Street wants more predictability than ever," says James Lam, president of Enterprise Risk Solutions, a risk-management firm in New York. Hence Duke's naming of a chief risk officer, a step first taken by banks and brokerage houses in the 1990s. Duke joined the trend in May, reflecting its evolution from being a highly regulated utility serving power to North and South Carolina into a global energy merchant in competitive markets. Electricity deregulation, most observers believe, will come to the Carolinas in 2001.

"The business profile is higher risk," says Mr. Osborne, but with it comes the hope of future 12% to 14% annual profit growth, instead of the 8% to 10% growth that Duke is projecting to analysts these days.

The enormous electricity-price swings this summer create one more risk for Duke Energy: What if the Flawed Competition scenario and its resulting price spikes lead to a political backlash? "All of this could roll back the momentum you have with deregulation," which is crucial to Duke's aggressive power-plant buildup, says Mr. Priory. "It would change our strategy rather dramatically." But the CEO hastens to add: "I don't see that on the horizon."