McKinsey&Company

APRIL 2015

Beyond the storm—value growth in the EU power sector

Sebastien Leger and Thomas Vahlenkamp

The European power sector has been hit by macroeconomic and industry-specific factors that led to overcapacity and low prices: We examine how incumbents could increase the sector value pools by 2020.

Over the last five years, the EU power sector has been hit by a "perfect storm" of macroeconomic and industry-specific factors that have led to overcapacity and low prices. As a result, the region's large publicly traded utilities have, on average, lost half of their market capitalization since 2008, destroying around EUR 500 billion of shareholder value.

Beyond its financial impact, the crisis has fundamentally changed the game and called the business model of utilities into question. Many structural and asset-related competitive advantages have disappeared, while additional skills are required to compete in growth areas such as renewable energy and new downstream activities.

Market fundamentals remain weak and suggest that the "storm" could continue for the foreseeable future. Nevertheless, we believe that the impact of these continuing downward trends could be offset by the actions currently being taken by utilities, such as operational improvement and capacity rationalization. Therefore, our base-case scenario—ie, if no additional action is taken—is a stabilization of the value pools for the sector and for utilities by 2020.

We also believe that, on top of this base case, there is a significant value upside potential (of up to more than 40 percent) that could be won by pushing further operational excellence, solving the generation capacity dilemma and capturing market share from growth in new value pockets. This could bring the sector value pools back to 2008 levels by 2020.

Incumbent utilities will only drive this recovery and realize the upside if they make bold moves, eg, radically re-allocating capital and developing completely new organizational capabilities. Research from the McKinsey Strategy Practice suggests that in challenged and transforming industries only those companies that take step changes and make unprecedented shifts to their investments in both assets and capabilities are able to survive and grow.

Most incumbent utilities are already pursuing key recovery activities with similar levers, and new strategies are just emerging, e.g., regional growth, refocusing along the value chain. Going forward, however, utilities will need to adopt a more radical approach to differentiate themselves. These actions will be needed across a range of levers, eg, portfolio restructuring, operational excellence, new skill development and innovation, and financial engineering.

The paradigm shift in the sector, with higher and more evenly spread value across the value chain, seems irreversible. The identified upside will be tough for incumbent utilities to capture, and it is rather unlikely that they will all be able to take part.

This is excerpted from the report *Beyond the storm—value growth in the EU power sector,* published in December 2014.

Sebastien Leger is a principal in McKinsey's Paris office, and **Thomas Vahlenkamp** is a director in the Düsseldorf office and global leader of the Electric Power & Natural Gas Practice.