

■ Industry Report | Utilities

Power plays

By Omar Abbosh, James C. Hendrickson and Etienne Deffarges

Decades of regulatory policy swings and a bewildering array of business models have created a sector that defies a simple interpretation of performance. Understanding this complex industry requires both historical and forward-looking analyses.



■ There was a time when utility stocks, a largely homogeneous group, were considered first cousins to bonds as an investment safe haven. Not any longer. Today, they are far more diverse and increasingly risky, particularly in certain sectors. Globally, the industry has gone through wrenching changes over the past 20 years. As governments have experimented with various regulatory formulas, many companies have attempted to exploit the opening markets. But few have succeeded. In addition, the growth in demand has slowed in developed countries. These factors have made it difficult for utility company executives to deliver the kind of consistent, profitable growth that investors demand. Since the equity market peak of 2000, nearly \$47 billion in aggregate global market value has been destroyed in the sector.

No, these are not your grandmother's utility stocks.

The shifting regulatory environment has helped create a unique industry. While some national markets essentially function as monopolies, market share worldwide is extraordinarily fragmented, and there is no cluster of leaders that dominates as in most other global sectors. In the United States alone, there are more than 100 utility companies with more than \$1 billion in assets. And because of national monopolies, the world's 20 largest utilities are all based outside of the United States.

Privatization has been a difficult process everywhere. Two decades of regulatory policy swings have produced only a few fully open markets—in the United Kingdom, Australia and most of Scandinavia. Most national markets are either fully regulated or some version of an open-regulated hybrid. In the United States, for

example, only 40 percent of the power-generation sector and 20 percent of the end-user consumer sector are deregulated. Such semiregulated markets present a patchwork operating climate for utility managers, with the degree of regulatory constraint demarcated along geographic lines, functional lines or both.

The utilities sector has gone through three major phases during the past decade. In the United States, the 1990s were characterized first by the *diversification* phase (1992–1996), during which restrictions on foreign and cross-industry investment were lifted, and regulated utilities expanded into noncore areas or regions (for example, overseas project-finance ventures). This stage was followed by the *merchant energy* phase (1996–2000), during which the wholesale power markets were largely deregulated and new physical and nonphysical commodity markets emerged. The past three years has seen a *return to basics* phase in response to the collapse of the competitive wholesale market; the emphasis has been on stabilizing and optimizing regulated cash flows.

In Western Europe, the corresponding phases are *privatization and incorporation, industry restructuring with creation of market mechanisms* and, finally, the *drive for customers and operational excellence*. Different countries are at different stages of this evolution.

An industry-specific model

Despite the complexity of the utilities industry, most industry analysis looks to past performance as a predictor of future performance. Although historical analysis is useful, Accenture believes it is not enough in such a diverse, ever-changing market. We believe understanding the drivers of long-term sustainable high

performance requires a forward-looking, capabilities-based approach.

As part of our High Performance Business initiative, we have devised a new methodology for understanding the utilities industry, and have identified what made companies in this sector succeed in the past as well as what will make them top performers in the future. (For additional information on our methodology, see “About the research,” page 52.)

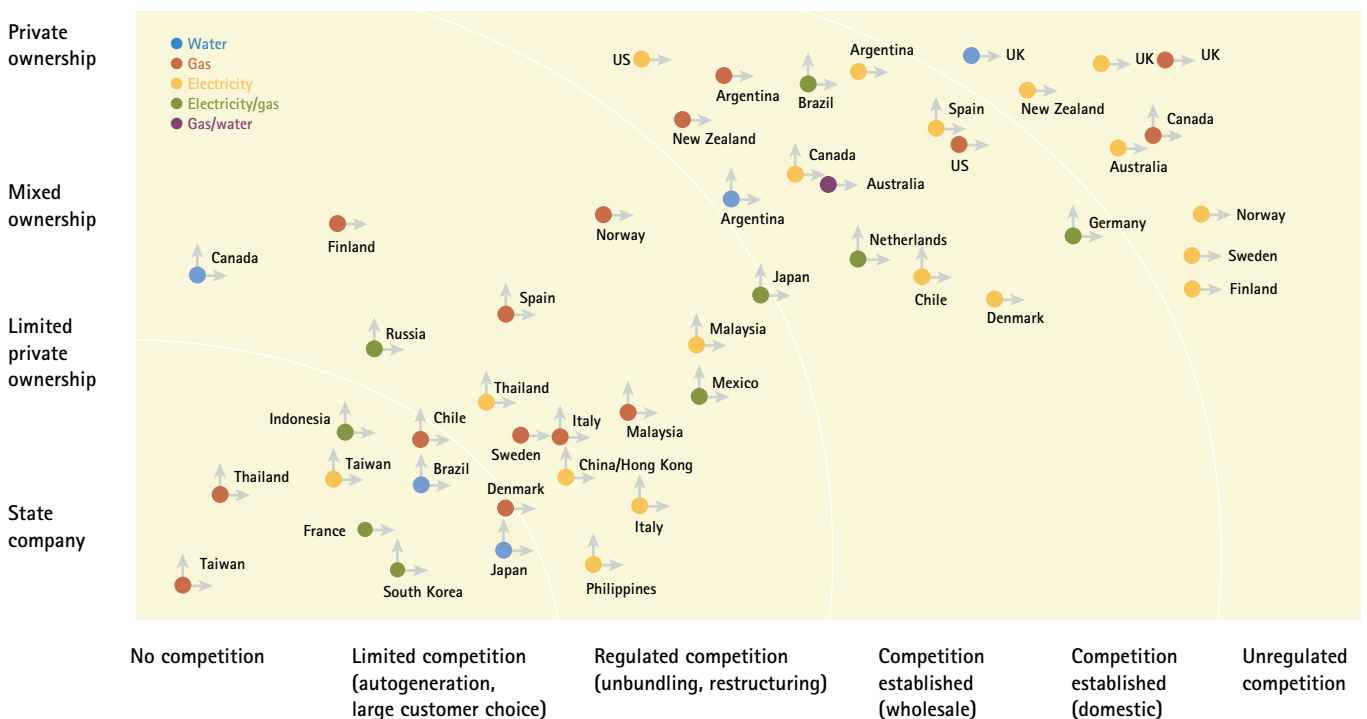
In both Europe and the United States, certain business models have proven most successful, particularly in the period after the diversification and merchant energy bubbles were deflated. For example, the regulated network delivery model and the traditional regulated vertically inte-

grated model (such as a power utility that generates, distributes and sells electricity to consumers within a geographically defined area, with rates set by a public commission) outperformed companies, such as merchant generators or retailers, that were operating in the more competitive sectors.

Many of the segment-focused approaches were characterized by poor investment decisions, particularly during the diversification and merchant energy phases. A number of traditional US utilities, for example, attempted to invest in newly privatized Latin American utilities after most of the available profits had been extracted; their late investment timing often led to large write-offs. This weakened their balance

Utility-sector competition and nature of ownership

Despite many regulatory policy changes, there are only a few fully open markets—in the United Kingdom, Australia and most of Scandinavia. The rest of the world's markets have either no competition—as in Taiwan, Thailand and Canada—or are hybrids.



SOURCE: ACCENTURE ANALYSIS

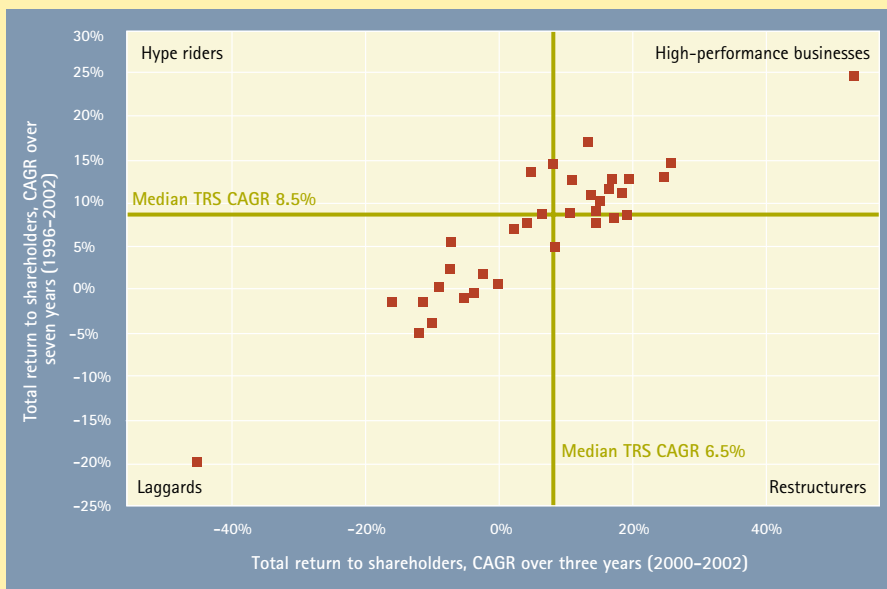
About the research

Accenture's preliminary high-performance research was conducted among 31 US and 19 Western European utilities (in water, gas and electricity). While utilities in the Asia Pacific region are among the largest in the world, in our experience they have tended to follow structural precedents

set in Western Europe and the United States—and therefore were not included in this research. We have used our base of experience in Asia Pacific markets, however, as an informal framework for the comparison and verification of formal findings.

Total return-to-shareholder performance of US utilities

3-year vs. 7-year TRS (CAGR)

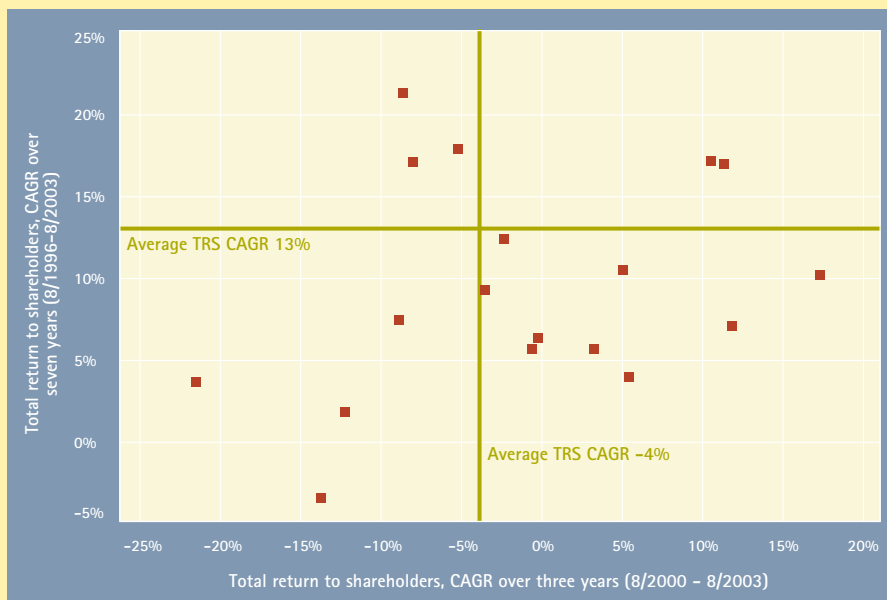


At Accenture, we are interested not only in historical performance but also in the interplay of historical drivers with likely future drivers. The entire high-performance business effort is intended to address C-level questions of how industry performance levels can be raised.

To understand the historical performance, we used Accenture's overall high-performance business metrics: three-, five- and seven-year total return to shareholders as an indicator of performance during varying economic conditions. We then looked at revenue growth, taking the compound annual growth rate for those same three-, five- and seven-year periods. In addition, we looked at the return on invested capital, which is a fundamental measure of value creation.

Total return-to-shareholder performance of European utilities

3-year vs. 7-year TRS (CAGR)



Finally, we looked at the ratio of the enterprise value to the invested capital. For an industry as capital-intensive as utilities, strong capital management is critical to performance. The high-performance utilities were in the top quartile for total return to shareholders for all three time periods.

Our metrics for future performance are based on a somewhat different set of criteria: the trend for return on invested capital, looking particularly for companies that have improved their return on capital; financial flexibility, which we determined by looking at the cash available as well as the company's credit rating; future growth value, which is an indication of the market's perception; regulatory advantage, looking at items like pending cases, envi-

ronmental liabilities and past successes in dealing with regulators; and, finally, strategic positioning and management capabilities, which we based on our own qualitative assessment.

Strategic positioning looked at three subfactors: 1) the markets in which the company is focusing; 2) the quality of the assets to support that market positioning, such as the types and ages of power plants; and 3) the business model and the company's capabilities to support its market positioning. Significant weight was placed on the quality of the business model. Leaders were expected to have, at a minimum, a few key capabilities, such as being market facing, integrated at the points of commercial value creation—such as the linkage between generation and retail—and well balanced along the value chain. Laggards were typically companies organized into functional silos with weak integration between the functional areas.

The measurement of management capabilities, like strategic positioning, is subjective. It is based on the depth of experience of the management team, the management team's experience outside the industry, the team's willingness to change and take measured risks and, finally, the strength of board oversight.

To identify high performers, we gave equal weight to historical drivers and likely future drivers. Of the 50 companies we analyzed, only seven—three in the United States and four in Europe—met our criteria for high-performance business.

sheets, raising their capital costs and leading to widespread “empty growth”—revenue increases without value creation.

Initially, the market valued aggressive growth investment, driving many utility-related stocks to hollow valuations. As these growth stories failed to materialize, the capital markets came to value the steady income streams of regulated businesses more highly than the potentially superior long-term income streams available in unregulated businesses. In both cases, the pendulum may have swung too far.

During the period Accenture analyzed, only a few publicly held companies proved capable of consistently creating shareholder value in this climate, and most of them used a core-focused vertically integrated or balanced portfolio model. Our research suggests that what set these companies apart was their excellence in two key areas: regulatory management and focused, disciplined execution. These companies tended to selectively exploit the opening markets—Atlanta-based Southern Company's establishment and spinoff of Mirant, for example—while protecting their core regulated businesses.

Regulatory management

For utilities, no skill is more important than the ability to manage and extract value from the regulatory environment. Advocates of privatization confront a deep residual belief that utilities are “natural monopolies.” One major result of this attitude is an operating climate in which constant uncertainty caused by public policy vacillation, political intervention

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and ever-present environmental pressures are ways of life.

Executives at high-performing utilities have learned how to navigate the regulatory waters—building concrete, constructive regulatory relationships that can produce win-win outcomes. They expect to influence and drive regulatory outcomes proactively—but are realistic about the political climate. This industry-specific mastery takes many forms, but they all have three things in common—they anticipate what will happen and try to manage it proactively; they are long-term-oriented; and they are only moderately adversarial.

For some, regulatory management takes the form of improving customer satisfaction—for example, linking customer satisfaction to gain-sharing or securing higher allowed rates of return. For others, it is all about asset-base management (for example, getting permission to include environmental compliance spending costs in the rate base). It can also mean becoming adept at negotiating with regulators to secure advantageous terms for a transition to open markets or using the same negotiating abilities to retain portfolio management options that otherwise would not be available. For instance, a few companies have negotiated with regulators to transfer a money-losing power plant from a competitive affiliate into its regulated rate structure.

Execution and asset optimization

Historically, operating excellence has been a predictor of superior performance in the European utilities market; this is less true in US markets, because of regulatory disincentives.

Accenture research indicates that the kind of operating practices that underlie strong performance in other capital-intensive industries will be a part of the base capabilities of high-performing utilities. Capital allocation and planning, asset management, and data management and analysis will become increasingly important. The aging of the workforce will also require better work management to improve productivity: workflow capture and planning, design and preparation, delivery and execution, and support.

With the growing importance of operating capabilities and continued price pressures, Accenture expects that leading utility companies will shed noncore activities as they increasingly embrace business process outsourcing. There also will be a corresponding increase in the number of outsourcing providers to service these companies.

Utility executives in developed markets such as the United States, the United Kingdom, Canada and Spain will see outsourcing as a way to tap best practices, gain virtual scale, obtain workforce flexibility, optimize asset use and leverage discretionary capital. Utilities in developing markets such as China and India will see outsourcing as a way to leapfrog learning curves and so-called diversionary investments in noncore infrastructures—call centers, for example—to focus capital investment on core generating or distribution capacities.

Adoption will be more gradual in the United States due to the fragmented state of the market and strong political resistance. However, this will be a transitory pause. The continued raising of the competitive performance bar will force change.

Selective merger and acquisition activity—informed by clear strategic rationale, disciplined execution and a focus on post-merger integration—will be a critical contributor to high performance in the utilities sector. Most of the activity will involve specific assets, such as power plants and pipelines, designed to round out a company's value chain or to exploit favorable market segments. Whole company M&A will occur, but the wave of acquisitions many anticipate is likely overestimated. Few truly synergistic combinations exist, and most companies are not yet prepared to exploit the synergies that do exist, such as customer scale.

Strategic M&A

An important litmus test of high-performance, M&A strategy will be fiscal restraint, particularly during periods of low interest rates. The temptation to pursue high-risk, growth-at-all-cost strategies historically is strongest during these periods—and so is the record of financial disasters. Acquirers should take their time and find the right deals.

There is no perfect generic acquisition profile. Most whole company M&A will fall into one of two categories: value-based deals viewed as portfolio investments, or very selective complementary combinations that can build scale or provide value chain integration.

Moreover, the regulatory and political difficulties that surround nearly every phase in the acquisition of scale through M&A are most acute when individual voters or taxpayers are involved. From a regulatory perspective, would-be acquirers will do well to act during periods of excess capacity, when any possible service-level impacts will be minimized.

And they should shore up their political base before acting.

The potential superior returns in utilities have not gone unnoticed—particularly among value investors. New types of institutional participants, specifically private equity firms such as Kohlberg Kravis Roberts & Company and Texas Pacific Group, have entered the sector with recently announced purchases of regulated utilities (Portland General Electric by Texas Pacific, for example). A small core of synergistic combinations is also possible and will gradually become apparent over the next few years.

Success in acquisitions will be based on a number of factors. First, thorough due diligence is a must. Historically, the track record of utilities acquisitions has been mixed at best. Overvaluation has been endemic as acquirers have systematically overvalued synergies and bid up premiums. For example, during the wholesale boom, late entrants grossly overpaid for plants, particularly in the United States, that have little, if any, value today. Others overpaid to acquire customer blocks to chase elusive scale.

Second, the company will need a clear strategy and an understanding of how value is created. Third, it will need strong post-merger integration planning and active portfolio management. Winners will have acquisition platforms built around standardization and simplicity to allow the rapid realization of benefits, and will continuously reassess their portfolios and be aggressive in shedding and adding pieces to their model as the market changes. The best analogy is in the financial services industry, where Bank of

As the global economy improves, utilities will face growing competition for investment capital.

America Corporation set a standard for success in acquisitions.

Emerging strategic models

Accenture believes that in the future, high performance will be based on two very broad strategies that will build on the factors outlined above.

Sector roll-ups

These utilities will either concentrate on one of the traditional horizontal businesses of the value chain (generation, transmission, distribution or supply for both commercial and individual customers) or pursue a vertical integration strategy. Within their chosen segment, they will adopt a sector roll-up strategy, pursuing dominant market share and focusing on depth of expertise, sustainable position and market efficiency.

In Europe, the prime example of the vertical integration model is Electricité de France's nuclear division, which has used its deep expertise in reactor construction, operations and the whole value chain to build a significant presence in markets around the world. EDF typically develops a vertical integration strategy in its local market and tends to replicate the same model abroad.

In the United States, Exelon Corporation and Entergy Corporation have demonstrated another sector roll-up model by purchasing still-active, fully amortized nuclear reactors from US utilities at distressed prices. At the time of these purchases, there was something of a buyers' market for nuclear facilities as their owners were looking to extricate themselves from perceived liabilities. Exelon has amassed an asset portfolio representing approximately 20 percent

of the US nuclear industry's power capacity, and is one of the best-performing utilities in our research universe.

Integrated portfolio managers

The second likely high-performance model will be adopted by utilities that manage a functionally and geographically diverse mix of regulated and unregulated businesses. The challenge is then to maintain their asset portfolio in a dynamic way, continuously rebalancing it to optimize the risk/reward profile. One example of this model is the Spanish utility Iberdrola.

RWE, the giant German multi-utility, which has more than 200 energy and utility interests in its portfolio, is a good example of a company with the potential to drive a strong cross-sector approach. EDF and, to a certain extent, the Spanish utility Endesa, which invested in Latin America a decade ago, provide another variation of this model: the multinational approach. These utilities used the cash flows generated in their protected or difficult-to-enter domestic energy markets as well as their debt capacity to purchase and operate utilities in more open overseas markets.

In the United States, the cross-sector approach has a different flavor—either regional diversification and growth or value chain expansion and integration. Again, Exelon is a good example of regional expansion, while Dominion is emerging as a potential model for integrated value chain management.

As the global economy improves, utilities will face increasing competition for investment capital; investors are likely to demand higher returns than they do now. To maintain current stock valua-

tions, utilities will be challenged to deliver growth in excess of the organic industry rates, which currently range from 2 percent to 5 percent, depending on the region.

Given these modest growth rates, companies pursuing either the sector roll-up or integrated portfolio models with high-performance aspirations will have to turn to operational improvements, M&A (and efficient post-merger implementation), increased regulatory management, and portfolio and asset optimization management strategies for success. For portfolio managers, using regulated businesses as a hedge against earnings-growth engines will be fundamental to managing market cycles.

Given regulatory fundamentals, creating and managing shareholder value will continue to be difficult. A steady wave of disruptive microchanges continues to reshape the industry, and the best utility executives will not simply react to changes in their operating environments: They will do the changing. ■

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