SUCCESSFULLY MANAGING MAJOR UTILITY BUSINESS SPIN-OFFS AND DIVESTITURES
UNLOCKING VALUE THROUGH INCREASED FOCUS

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As the US energy industry experiences massive change – upheaval in technologies, customer preferences and economics – many executives are asking themselves whether the scope and focus of their businesses are appropriate. What is the right balance between the breadth and focus of the business? At what point does the stock market value the business portfolio less than the sum of its parts? Are there non-core components of the business that are undervalued within the combined entity?

Executives across the energy industry have been answering these questions in ways that redefine their businesses, as evidenced by the recent wave of business separations, including spin-offs, divestitures, sales of business units, and creations of so-called “yieldcos.” In several prominent cases, these separations have been driven by private equity and activist investors who thought the market undervalued segments of the energy businesses. The prevalence of utility business separations has dramatically increased in North America during the past 12 to 18 months (see Exhibit 1). Many utilities have been redefining the scope of their businesses, often abandoning participation in many parts of the value chain to increase focus on the core activities.

As utilities divest business units, leaders should also ask themselves how to separate while maintaining operational performance and profits. Without a roadmap for keeping profit margins stable, the divesting utility is in danger of compressing profits and scuttling an opportunity to become a better, stronger business than before.

While much has been written on how to capture value from a merger, the topic of successfully separating a business unit while maintaining operational performance and profitability has received less attention. In many ways, business separations can be even more challenging than mergers. Strong leadership and a sound implementation approach are required to protect value and ensure that the remaining entities are effectively positioned to thrive in the future.

**EXHIBIT 1: BUSINESS SEPARATION ACTIVITY**

VALUE OF BUSINESS UNIT DIVESTITURES BY NORTH AMERICAN UTILITIES ($BILLION)

BY YEAR ANNOUNCED, WHEN VALUE WAS PUBLICALLY DISCLOSED

<table>
<thead>
<tr>
<th>Year</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>1.0</td>
</tr>
<tr>
<td>2007</td>
<td>1.8</td>
</tr>
<tr>
<td>2008</td>
<td>2.1</td>
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<td>2009</td>
<td>1.0</td>
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<tr>
<td>2010</td>
<td>0.0</td>
</tr>
<tr>
<td>2011</td>
<td>0.2</td>
</tr>
<tr>
<td>2012</td>
<td>1.9</td>
</tr>
<tr>
<td>2013</td>
<td>3.7</td>
</tr>
<tr>
<td>2014</td>
<td>13.9</td>
</tr>
</tbody>
</table>

Source: SNL databases; Oliver Wyman analysis
Utility management’s primary objective and greatest challenge for a business separation is to unlock value from the business unit or asset being separated while protecting the value and profitability of the remaining businesses. Corporate and support functions that were previously shared across multiple business units must be separated to serve each of the future businesses.

Costs such as senior executive salaries and software licenses are allocated across the entire business. After the separation of a business unit, these costs are allocated over a smaller base, therefore reducing profit margins if all else is held equal. The same situation arises from the costs of corporate staff groups, information technology system maintenance and infrastructure, physical assets such as corporate headquarters and shared contracts and licenses, just to name a few. In fact, all shared expenses create stranded costs or dis-synergies if they cannot be scaled to meet the needs of the separate businesses.

To maintain profit margins post-separation, companies must identify these dis-synergies and eliminate or offset them through other cost reductions. Inevitably the future businesses will have new mandates (otherwise, why split?) that need to be considered.

**EXHIBIT 2: THE DIS-SYNERGIES CHALLENGE – ILLUSTRATIVE EXAMPLE**

Merging two entities often reduces overall corporate and support services costs through synergies and economies of scale.

Separating two entities brings the risk of creating stranded costs or dis-synergies and a higher total cost base compared with the combined entity.

Source: Oliver Wyman analysis
when determining what can be reduced and what can be done differently in the future. For instance, a utility spinning off its nuclear generation portfolio or energy trading business is likely to have a very different risk tolerance in its business going forward. Pressure must be applied appropriately to revise policies and remove cost deemed unnecessary for the future ongoing business.

**MANAGE AND LEAD AN ORGANIZED SEPARATION AND TRANSITION**

Through Oliver Wyman’s experience supporting energy company separations, we have found the following four principles to be critical to delivering success in these transitions:

1. **Protect and then create value.** The top priority lies in minimizing the impact of stranded costs or dis-synergies from separating shared functions and asset costs. Once the business has the right size of support infrastructure, focus can be turned toward creating value.

2. **Plan for post-close support.** Ideally, all functions associated with the separated and remaining businesses would be fully independent by transaction close. However, in reality, it is usually not feasible to fully separate and transition everything, particularly IT systems, before a transaction closes. Therefore, post-close support will likely be required. The companies must develop, structure, and price transition service agreements before close.

3. **Focus on the people.** Employees, customers, and other stakeholders will be affected by the business separation. Management must work hard to create a seamless transition. Employees will typically experience the most anxiety and potential change, requiring well-crafted and frequent communication, starting when the separation is announced and sustained through transaction close. Communicate, communicate, communicate.

4. **Apply rigorous project management.** A business separation is a complex transition to manage, and should be tackled with the same rigor one would apply to a merger or acquisition. A focused project management approach and dedicated resources are required to develop and manage transition plans, mitigate risks, eliminate or offset stranded costs or dis-synergies and help ensure day-one readiness.

**PROTECT AND THEN CREATE VALUE**

Managers must first protect value and then create value. The first step in separating the business unit is to decide whether each function, job, asset, system, contract, and process will stay with the utility, go with the separated unit, or be eliminated altogether.

Decisions regarding functions, jobs, or assets that are fully dedicated to a business unit are fairly straightforward as costs typically remain with that business unit. For employees or assets that are predominantly dedicated to one business, applying a rule of thumb helps with the decision. For example, employees who spend at least 75 percent of their time on one entity might go with that business. Similar thresholds could be applied to assets, like office space or warehouses.
Once the relatively straightforward separation discussions are completed, management must examine shared work groups, contracts, and assets to determine the level of resources needed to serve each business. For instance, if a benefits department of 10 employees serves a combined entity with two business units of equal size, initial evaluations may indicate that six benefits employees may be needed vs. five (half of the original department) to serve each business post-separation. The cost of this incremental resource represents a potential stranded cost or dis-synergy, lowering profits for the remaining businesses unless additional action is taken.

To avoid the cost increase of additional resources, management must challenge the status quo. This means rethinking the scope of services offered, adjusting service levels provided, and changing how services are delivered. In the case of the benefits group, job functions might be combined or redesigned so employees could work on both retirement and wellness benefits, rather than being specialized. Could the benefits department join the compensation department to share resources or reduce employment? Could benefits call center staffing be reduced by lowering service levels or by requiring employees to use self-service tools on-line?

This concept also applies to assets. For example, if a utility owns a shared building, and the remaining post-divestiture business occupies 80 percent of the space, management is left with 20 percent excess capacity. Instead of absorbing the increased costs, management should consider reconfiguring its building assets. Could the company consolidate staff in other office space and sell a building? Could the utility move to a smaller building? Can the company sub-lease the space?

### EXHIBIT 3: ELIMINATING DIS-SYNERGIES OR STRANDED COSTS IN CORPORATE FUNCTIONS

<table>
<thead>
<tr>
<th>LABOR COST EXAMPLES</th>
<th>NON-LABOR COST EXAMPLES</th>
<th>MITIGATING ACTIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dedicated or scalable costs</td>
<td>Inventory</td>
<td>Allocate dedicated resources to the business they serve.</td>
</tr>
<tr>
<td>Can be reduced proportionally</td>
<td>Servers</td>
<td>Scale resources, contracts, and assets to serve the future businesses under new strategies.</td>
</tr>
<tr>
<td>Shared and potentially stranded cost</td>
<td>Banking fees</td>
<td>Redesign roles and processes.</td>
</tr>
<tr>
<td>Changes potentially create excess capacity</td>
<td>Facilities</td>
<td>Scale back services offered by shared functions.</td>
</tr>
<tr>
<td>Compensation and benefits staff</td>
<td>IT applications</td>
<td>Reconfigure assets to scale back on costs.</td>
</tr>
<tr>
<td>Attorneys</td>
<td>Audit fees</td>
<td></td>
</tr>
<tr>
<td>Accounting and treasury staff</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investor relations staff</td>
<td>IT network infrastructure</td>
<td>Offset costs by reducing spending in areas that are independent of scale and scope.</td>
</tr>
<tr>
<td>IT security staff</td>
<td>Association membership dues</td>
<td>Re-engineer support to eliminate needs or convert to scalable costs wherever possible.</td>
</tr>
<tr>
<td>Budget staff</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Procurement staff and buyers</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Safety representatives</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Oliver Wyman analysis
Some stranded costs are unlikely to go away, such as the chief executive’s salary or the investor relations staff. The transition team must identify opportunities to offset these costs in other parts of the business. This is a tall order, because if improving operations were easy, the company would have already done it. But this is a critical step to avoid compromising the profitability of the remaining businesses. Functions that compare poorly to benchmarks from a cost standpoint should be challenged with aggressive cost reduction targets.

**PLAN FOR POST-CLOSE SUPPORT**

The parties involved with business separations typically desire to fully separate the businesses as quickly as possible. Many business unit separations have regulatory approval and transition timeframes from announcement to close of nine to 12 months, making it difficult if not impossible to fully transition all IT applications and, at times, infrastructure by the close date. Therefore, management often needs to establish plans to support separated businesses post-close until the transition of IT systems is complete. Many separations rely on a set of services between the two entities for some time period, sometimes even up to two years, after the close. Transition services, and the contracts by which they are governed, called transition service agreements or TSAs, add another level of complexity to manage during business separations.

Structuring and managing TSAs is challenging because this is outside of normal business operations for a utility. It requires a shift in mindset. Since the two previously related businesses will become separate legal entities with different parent companies, the TSA must be a formal contract, with stipulated terms and conditions such as limits of liability. In addition, most utilities are not structured to bill other companies for support services rendered from their corporate centers (as opposed to billing customers for electricity or gas). Regulatory rules regarding billing at cost vs. market price may also add complexity depending on which organizations (service companies vs. regulated utilities) are providing services. Further, the number of employees or contractors needed for the transitional services typically declines as the acquirer operates more independently. This uncertainty often leads employees to search for other opportunities and increases the likelihood of TSA employees leaving the company before their skills are no longer needed and the TSAs are complete. Utilities need to be creative in how they treat employees and structure employee separation payments or retention incentives during the terms of the TSAs.
FOCUS ON THE PEOPLE

Major changes such as business separations create uncertainty and anxiety for consumers, other stakeholders, and particularly for employees if communication and change are not managed adequately. Utilities should place as much emphasis on people as they do on traditional operations and strategy.

The transition team should develop a robust internal and external communication plan that begins with the announcement and provides sufficient updates through the close of the transaction. Keeping employees informed about the key issues that affect them (organizational structures and reporting, future positions, benefits, compensation, etc.) is a key determinant of success. The transition period can be used to highlight other important messages. For example, a recent client focused a series of communications during the transition period on reinforcing key messages around safety. Recognizing that employees may be distracted by the separation, the utility reminded its workforce of safety protocols to try to reduce the likelihood of any incidents.

Another client, in its efforts to do the right thing for employees, was able to improve morale during a tough time and reduce risk for the corporation. Among other efforts to minimize negative impacts on employees, this company offered voluntary separation incentives to targeted groups of employees who faced reductions. Employees welcomed the ability to control their own fate.

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**EXHIBIT 4: TRANSITION SERVICE AGREEMENT PREPARATION**

<table>
<thead>
<tr>
<th>Step</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Define scope of transition services</td>
</tr>
<tr>
<td>2</td>
<td>Estimate resource requirements</td>
</tr>
<tr>
<td>3</td>
<td>Estimate cost or price of services</td>
</tr>
<tr>
<td>4</td>
<td>Negotiate and agree on contract</td>
</tr>
<tr>
<td>5</td>
<td>Prepare to deliver services</td>
</tr>
</tbody>
</table>

- Definition and description of service
- Key service attributes and performance requirements or metrics
- Points of interaction between service provider and receiver
- Estimated duration, such as when divested unit will be self-sufficient and no longer need the service (or system)
- Staff or labor costs
  - Employees
  - Contractors or outside services
- Use of assets, such as
  - Information systems
  - Facilities
- Labor costs
  - Salaries or wages
  - Benefits loaders
  - Indirect costs (such as facilities, phones, systems)
- Non-labor costs
  - Depreciation or asset carrying charges
  - Share or allocation of contracts, such as IT licenses
- Profit, if applicable
  - Profit margin or percentage
  - Return on asset use
- Commercial terms
  - Limits of liability
  - Pricing
- Governance and dispute resolution mechanisms
- Develop mechanisms and processes to bill services
- Allocate staff to deliver service
- Assign key points of contact and accountabilities
  - Primary liaison or relationship lead
  - Accountable manager
- Ensure assignability rights are in place for contractual agreements.

Source: Oliver Wyman analysis
APPLY RIGOROUS PROJECT MANAGEMENT

A divestiture is a complex transition to manage and should be tackled with the same rigor as a merger or acquisition. Close dates may seem far away when a transaction is announced, but time moves quickly as a company works to implement the change. There are hundreds of tasks to be completed to ensure the company is ready for the transition on day one. Without a detailed plan and robust process to manage all these moving pieces, the utility faces considerable risk. Rigorous and proactive project management is vital.

Effective project management begins with management ownership. Senior leadership must quickly decide who will lead the remaining business, who will move to the acquirer, and who will govern the transition team. Clarity in the transition management structure avoids inertia and confusion.

Senior leadership should then establish objectives and guiding principles for the transition. These will provide guidance when difficult decisions must be made. For instance, a requirement to maintain profit margins would set the tone for stranded cost mitigation.

EXHIBIT 5: SHARED SERVICES TRANSITION COMPLEXITY

FUNCTIONAL SHARED SERVICES COMPARISON

Source: Oliver Wyman analysis
Assembling the right people to support the transition is critical. The transition team should be a cross-functional group of experienced people representing all functions and including key leaders who can work effectively across the organization. The transition team will be responsible for developing a detailed transition plan and managing to milestones. When assembling the team and planning for the transition, consider that some functions, such as information technology, are more challenging to transition than others.

A dedicated program management office or PMO should manage the transition process and preparation for the close of the separation. The PMO should set aggressive targets for the plan, both on timing and cost reduction. Unforeseen challenges and delays are bound to happen, so front-loading the work can help keep the transition on-track.

CONCLUSION

While there are numerous challenges that need to be overcome when separating a business, experience shows that these programs can be completed successfully and result in two businesses with higher collective value than their common origin. Setting aggressive transition targets for both timing and cost management can result in a leaner and more effective utility than before the separation. Periods of change such as these can also be used as catalysts to disrupt processes or functions that perform poorly, and these periods provide opportunities to think creatively about redesigning or enhancing support operations. While not simple, when done right, a business separation can set the stage to unlock value and position a utility for improved focus and strong financial and operational performance.
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