OLIVER WYMAN

Energy

Releasing the Value of Hidden Assets

As energy utilities complete their retreats from unsuccessful deregulated ventures, their financial statements contain less debt and suggest a higher-quality earnings outlook. Divesting assets identified as "discontinued operations" has shored up earnings across the sector. In fact, the power and gas sectors currently trade at record P/E multiples. However, there is a major earnings challenge on the horizon. Aging Transmission and Distribution (T&D) infrastructure and generation capacity shortages are now forcing many utilities to confront a major new build-out cycle.

Global competition for natural resources means this cycle will occur at a time when construction costs are high and still climbing. The pressure to squeeze earnings and cash flow from existing assets in order to fund this build-out is greater than ever.

To address this challenge, energy utilities should look at large, untapped sources of hidden value: their portfolios of what we call hidden assets. Unlocking the latent potential within these exploitable asset pools can yield major earnings contributions. This white paper suggests how to mine hidden assets within the T&D sector for electric and natural gas utilities.

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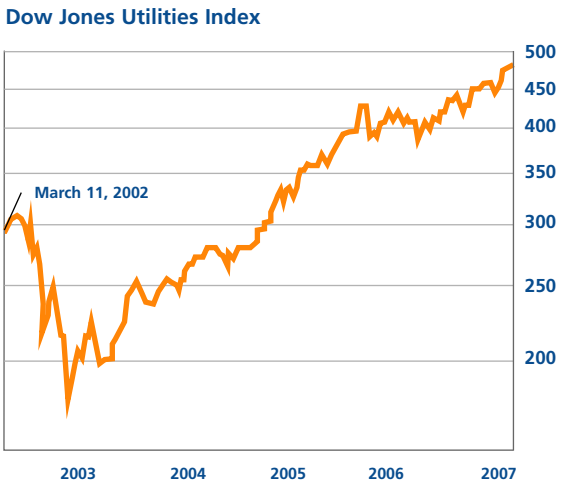
Uncertain growth prospects

During the 2003-06 period, the Dow Jones Utilities Index posted a healthy run-up, as shown in Exhibit 1. However, as the infrastructure build-out cycle takes hold, energy utilities will be hard-pressed to create the next wave of shareholder value, for several reasons:

- Power generators face large and growing capital needs from environmental retrofits, costs of new capacity (especially nuclear), and an impending Carbon Regime.
- T&D franchises are contending with aging infrastructure, capacity needs to support new generation, and increased expectations for service reliability.
- Rate freeze extensions coupled with utility commissions' desire to buffer consumers from rate shocks make the rate-setting process more risky.
- Population migration to the Sunbelt and continued retrenching of the U.S. manufacturing base is reducing load growth in Northeast and Midwestern states to a trickle.
- Utility M&A strategists, seeking growth through consolidation, are adapting to recent setbacks in the Exelon/PSEG and Constellation/FPL transactions.

Exhibit 1 **Utility investors have been pleased in recent years**



Source: Yahoo

Within many energy utilities, financial planning teams are growing anxious over the lack of compelling stories for sustained earnings growth in the face of the most expansive and expensive capacity build-out in history.

Utilities thus are approaching an inflection point concerning value creation, which raises several questions. Will utilities be content to accept lower P/E multiples and deliver shareholder value largely through promises of impending rate relief? Do rising interest rates and superior returns elsewhere suggest that investors will move to other sectors? Will energy utilities relinquish their recent run-up in shareholder equity?

A Universe of Hidden T&D Assets

Our research and work with utilities suggest that a significant source of earnings growth, contained a focus on hidden assets within existing operations, remains untapped. We'll focus here on the T&D sector as an example of the potential for capturing millions of dollars annually in new, highly profitable revenues.

Finding and deploying these hidden assets centers on the latent value in non-metered revenues. Every U.S. energy utility has extensive customer interactions not associated with the meter point. By "non-metered revenues," we mean revenues from the array of products, services, or assets not directly tied to the sale of energy, as shown in Exhibit 2.

Although the energy utility equivalent of "call waiting" or "voicemail" has never materialized, there is surprising growth in demand for products, services, assets, and technologies held by T&D providers. In fact, T&D utilities have expended billions of dollars and thousands of person-years over many decades building their hidden asset portfolios—a natural byproduct of developing an infrastructure and delivering energy to customers. Oliver Wyman's client work suggests that demand growth (estimated at 6-12% per year) in many of these non-metered areas is three to five times that of the typical T&D franchise. Demand has accelerated for several reasons:

- Customer needs are proliferating in areas such as growth-related expansion, options for higher service reliability, and advanced meter sets and related data.

- New, complementary technologies are advancing, including BPL, Wi-Fi, and broadband video applications.

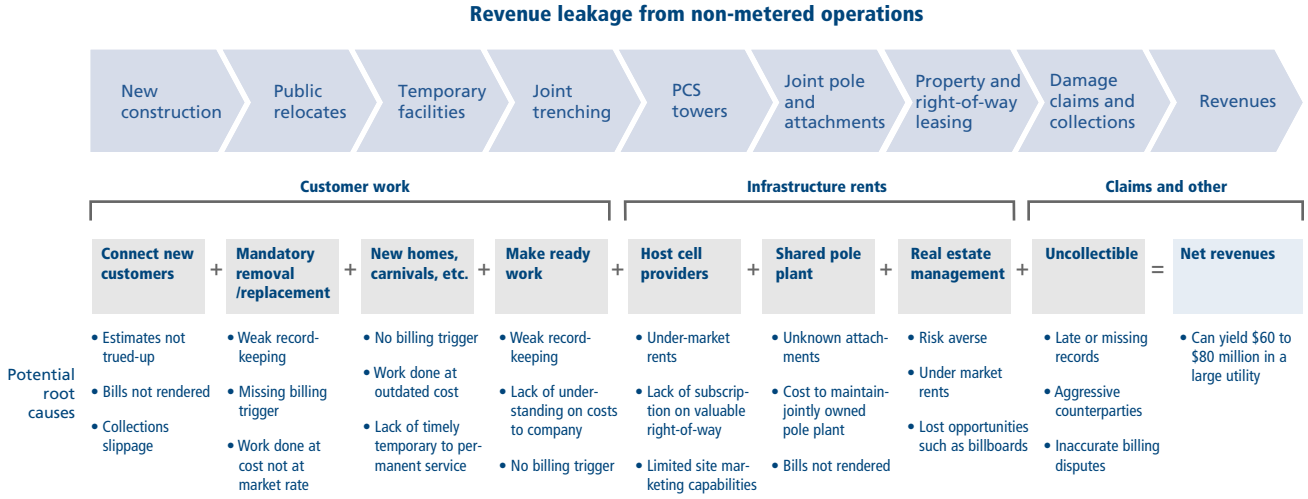
- Under-used real estate and rights-of-way have increased in value, including cellular towers, billboards, grazing rights, storage facility sites, and pole attachments.

- Core offerings are in growing demand, ranging from everyday applications like temporary electric service or joint pole maintenance to more exotic high-voltage construction work.

- A new wave of demand side-management products and services is emerging as California and Texas set the stage by allowing these capital dollars to be rate-based.

For many T&D utilities, demand for these services is beginning to crowd out more traditional activities tied to operating, maintaining, and refurbishing the network. Yet, many still tend to view these demands as a nuisance that distracts line crews, creates unreasonable customer expectations, saps budgeted resources, and undermines the brand. Our experience suggests that a T&D utility serving 3-5 million customers has the potential to realize between $40 million and $80 million in new revenues over a two- to three-year improvement cycle. Moreover, the costs to capture these revenues is negligible (as the labor needed is already employed) with gross margins in the 60-80% range.

Exhibit 2 **The universe of hidden T&D assets**



The Operational Barriers

To date, T&D utilities have not fully realized non-metered revenues or turned these opportunities into a growth business. Most of the reasons for this neglect are operational in nature:

- **Nobody is in charge.** This business-within-a-business cuts across the entire franchise; customers request these services all the time. Yet, the standard daily work—thousands of transactions involving linemen, real estate agents, field technicians, and engineering staff—is performed in the context of maintaining or expanding the network. Non-metered revenues are viewed as a "step-child" of operations with limited focus on the business, its size, customer value, growth potential, or contribution to earnings. No general manager has a P&L statement here and no one has a clear incentive to grow contribution.

- **Business development resources are in short supply.** Simply put, there are no "deal sharpies" in this crowd. Every time a customer asks for access to real estate, an upgrade to service, or the relocation of equipment, the request is handled locally with limited oversight. Discussions about cost versus market value rarely occur. Worse, the

service often is viewed as part of "good customer service." As a result, utilities perform many transactions for no charge or at well below cost. From a revenue realization perspective, this lack of commercial oversight costs millions.

- A **flawed revenue cycle**. The revenue cycle process for these services is complex, for the reasons listed in Exhibit 3.

  This complexity, coupled with a lack of dedicated resources, makes for weak process flows. Typically, we find the revenue cycle is undermined by four factors:

  – Lack of acknowledgement that a process with well-conceived roles, responsibilities, and communication links should exist

  – Inadequate attention to simplifying and efficiently routing necessary data to generate an invoice. For instance, billing triggers are often missing, leading to completion of field work with no invoice.

  – Lack of automated tools that would make event notification, estimating, execution, and invoicing seamless

  – Lack of a revenue assurance function, as revenue cycle transactions occur without a team devoted to stopping all the process leaks

- **Back office systems don't like complex billing.** If a utility does recognize the need for an invoice, producing the bill can be difficult. Customer information systems handling millions of meter points are not well-suited for these types of transactions. For the most part, these are complex "bills of one" that are unique to particular circumstances, such as a large public relocation job. Full realization of these revenues would suggest the development of a complex billing unit.

- **Financial accounting systems are fragmented.** Establishing metrics, setting targets, monitoring performance, and benchmarking performance levels all seem like a well-chanted corporate mantra. Yet, when it comes to non-metered revenues, most utilities get stuck on the first verse. Lack of meaningful financial or managerial accounting data makes it extremely difficult to track performance. Our experience is that these revenues are among the least understood line item on the income statement.

- **Lack of regulatory strategy devalues the opportunity**. Bringing these many opportunities, from billboards to gas leak checks, to the bottom line requires regulatory acumen. While some utilities have adopted strategies tied to recovery (e.g., contributions in aid of construction) and others rely on a wide variety of tariffs (e.g., temporary service), no utility has positioned these businesses for a clear upside. Instead, many wind up abandoning these lucrative businesses in the face of General Rate Case pressures. When the "earning between the regulatory lags" is over, they fold up shop. However, these are valuable assets, services, and capabilities that lend themselves to a regulatory solution where all parties can benefit—utilities can be rewarded for innovation, and customers can share in the gains.

- **Utility cultures favor engineering and operations.** Not surprisingly, utility staff would rather build or fix anything rather than trifle with even the most lucrative commercial terms or invoice data. Most field forces abhor the type of revenue cycle work-outs advocated here. Hence, the culture does not embrace the opportunity and many continue to give away the store in the name of good customer service.

Exhibit 3 **Revenue cycle characteristics**

- Many locations across the service territory
- Constant flow of high-value customers
- Customers care deeply about the experience
- Served by many employees, so many of moments of truth
- Heavy reliance on first-line supervisors to make it work
- Employees view as a lower priority; nobody owns results
- Complex, paper-intensive billing process
- Training focused on safety and operational procedures
- Limited financial and performance reporting
- Undefined performance metrics and benchmarks
- Regulatory strategies disconnected and ad hoc

How to Make It Work

With all these tough issues, how does one simply get the cash in the door? In our experience, the most effective approach runs along four straightforward steps summarized in Exhibit 4 and elaborated below.

1. Identify the leakage and its root causes. First, mine the financial system for transaction values and types. Like a divining rod, most ERP financial systems extend their reach beyond company walls to customers and partners. This data not only identifies transaction volumes and revenue dollars by region and district, it can also offer intra-company benchmarks to reveal, for instance, why it is that Region A bills three times the pole attachment revenues as Region B. Coupled with diagnostic interviews of field staff, a number of hypotheses for root causes rapidly appear.

2. Quantify how much can be captured and the ROI. This is an exercise in revenue cycle process workouts coupled with a sound financial model. After unearthing the details of a revenue cycle process, even when processes are sketchy or haphazard, you are in a good position to determine what the value of making investments will be. As one example, Exhibit 5 lays out the type of work needed for pole attachments. Most utilities recover a fraction of their attachment revenues, much less the costs of making available jointly owned poles. We routinely find a host of issues in this type of arcane process.

3. Capture the revenues by devising tailored solutions. This is a multi-dimensional issue and it requires solutions on a variety of fronts, including:

Exhibit 4 **Getting to the earnings**

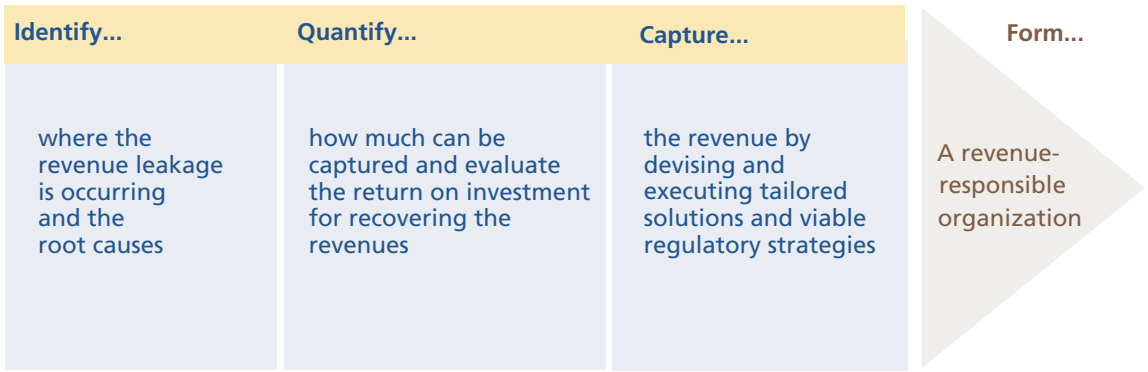
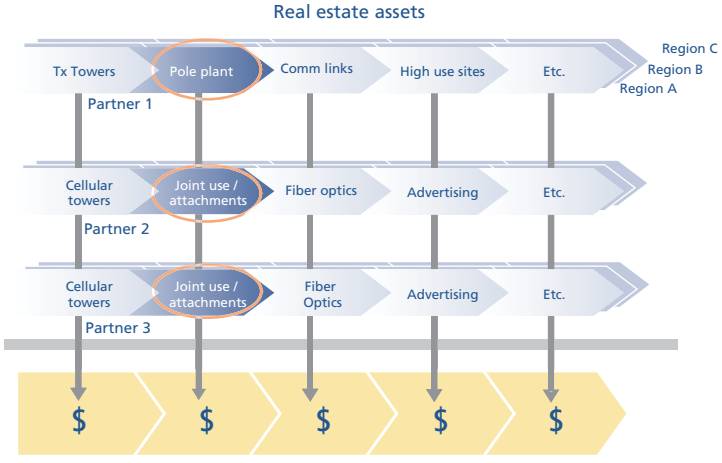


Exhibit 5 **Pole attachment process checks**



Sub-objectives (preliminary)

- Recover lost revenue
- Protect against over-billing
- Ensure cost recovery
- Reconcile attachment discrepancies (between owners and attachers)
- Ensure an organized process for managing attachment requests
- Coordinate pre-inspection, make-ready, and post-completion
- Streamline record-keeping, reporting, and billing functions
- Establish evergreen audit policies

- Process work-outs
- Stronger communication flows
- Paperwork automation and simplification
- Establishing billing unit rates and standard prices
- Concerted efforts to free up linemen from paperwork and insert administrative resources
- Incorporation of stand-alone, complex billing units
- Redesign of financial systems and financial reporting for tracking purposes
- Assignment of business developers to grow and manage revenues
- Establishing proper credit scoring and other risk tools
- Upgrading collections functions
- Developing standard legal terms and conditions

Given the level of organizational change required and the amount of potential upside, we advocate pursuing these changes in waves as opposed to trying to attack every revenue cycle simultaneously. This may mean working on three to five revenue cycles at a time (e.g., start with billboards, pole attachments, and damage claims). Look for high value, simple changes that don't have unwieldy implementation risks.

4. Form a revenue-responsible organization. This does not imply rethinking core responsibilities in the field for the execution of core work. Rather, it means focusing on the organization that does not exist, namely, the Front Office—the classic business development functions associated with conceiving and executing market strategy, such as product development, pricing, promotions, and distribution channels. Assemble a function accountable for revenue realization and create a formal business-within-a-business structure. Infuse this business with a profit and loss (P&L) statement and name a general manager. This includes working carefully with legal, credit, risk and regulatory disciplines to effectively position the business.

Closely proceeding along these four steps will help to avoid the inevitable turf wars and boundary disputes associated with a cross-functional process that has no owner. The trick is to not allow the systematic realization of quick wins to get bogged down by overly complicated, perfect fixes. It's critical to break through the culture with rapid execution.

* * *

Any CFO or CEO should be delighted to find an unexpected $50 million in new earnings contribution from a latent source, particularly since the investments needed to realize the revenues are already in place. The energy utility equivalent of "call waiting" is a viable growth strategy. It just needs to be recognized as such and released from the operational limitations that bind it.❖

OLIVER WYMAN

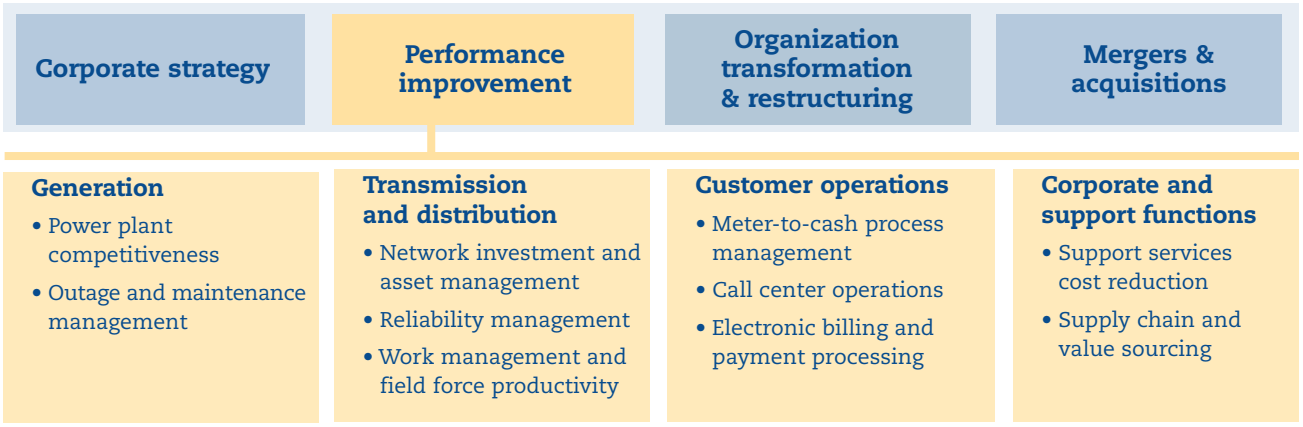
Oliver Wyman

Oliver Wyman is building the leading global management consultancy, combining deep industry knowledge with specialized expertise in strategy, operations, risk management, organizational transformation, and leadership development. The firm works with clients across a range of industries to deliver sustained shareholder value growth. We help managers to anticipate changes in customer priorities and the competitive environment, and then design their businesses, improve their operations and risk profile, and accelerate their organizational performance to seize the most attractive opportunities.

Oliver Wyman's Energy Practice

Our dedicated consultants have significant experience in the energy and utilities sector. Previous clients include more than 75 electric and natural gas utilities in North America and Europe, as well as a range of unregulated service providers to energy companies and utilities.

Practice areas:



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