

Ensuring Recovery by Bolstering the Bottom Line

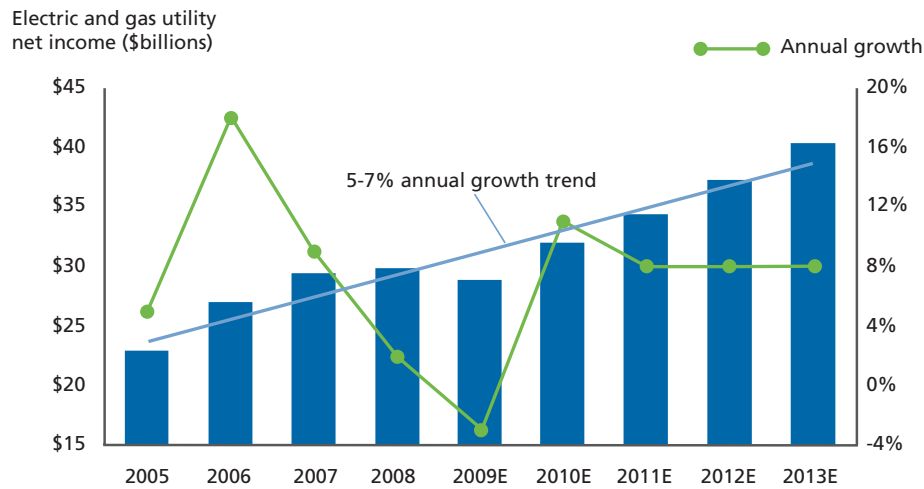
A slow and uneven recovery will not solve utilities' earnings problems. To get back on track, they must quickly focus on a handful of measures that will grow revenues and cut expenses.

The global economic recession may be ending, but its repercussions could last for years. The strength of the current recovery is uncertain, with the distinct possibility of a long period of stops and starts. Electric and natural gas utilities can not just count on an improving economy. To start growing earnings again, utilities need to take action on several high-potential fronts—and sooner rather than later.

Earnings growth rates have fallen over the past three years, reaching a paltry 2% in 2008. With declines likely for 2009, investors expect that earnings will rebound by 2010, as shown in Exhibit 1. Our analysis suggests that pre-tax results will have to improve by \$4 to \$5 billion industry-wide in order to meet expectations for 2010—an improvement of almost 12%. A stronger economy would certainly help in this regard, but to close at least some of the gap, we expect that utilities will have to take short-term measures to enhance revenues or cut expenses. Taking these actions now also raises the odds of returning to the long-term earnings growth trend of 5–7% per year.

Managers may be tempted to pile on further spending freezes or lay off more staff. But selective and strategic actions will yield a higher return with a lower risk of hurting customer satisfaction or hobbling operations. These actions will also pay off over the longer term. Investors expect significant, sustained earnings growth for the next four years. Should utilities' planned investments, expected rate base growth, and rate increases be delayed or fall short of expectations, these firms will have to depend on sustained operations improvement initiatives in order to stay on course.

Exhibit 1 Investors expect utility earnings to get back on track



E=Estimate

Source: Value Line; Oliver Wyman analysis of electric and natural gas utilities

Actions to Start Now

Our experience working with leading utilities suggests that focusing on five areas, as shown in Exhibit 2, can yield improvements to the bottom line in short order:

1. Revenue leakage
2. Customer care
3. Transmission and distribution
4. Shared services
5. General expenses

1. Measures that plug revenue leakage may hold the most potential for increasing revenue and EBITDA for utilities in the short term, but they may also be the least understood.¹ Opportunities abound for getting paid fully for throughput (in kWh or Mcf), by addressing technical loss (through the transmission and distribution system or company use), operations loss (with unmetered or unbilled revenue), or asset loss (through theft).

Besides theft, the largest sources of addressable revenue leakage usually lie in metering and billing.

Defective meters, meters bypassed during construction), orphan meters, billing with inaccurate rates, and consumption on inactive meters should all be examined closely.

Separate from throughput, the sluggish economy raises the value of another look at non-metered revenue and cost-recovery opportunities that can unlock sources of hidden value. Non-metered opportunities include extracting additional value from real estate, facilities, and equipment holdings, or seeking fees or reimbursement for utility work or service. With revenue initiatives, it is critical to understand what is causing the leakage and how big the opportunity is.

2. Customer care initiatives, such as improving collections performance, can sharply improve expense and cash flow results in a difficult economic environment. Identify those areas—notably specific collections process steps and select customers—where near-term efforts will have the greatest impact. Collections opportunities can be captured by:

- Strengthening the collections process by improving upstream work efforts (e.g., sign-up, billing) to get downstream results

¹ See “Releasing the Value of Hidden Assets”

- Targeting and tailoring collections efforts through advanced customer segmentation
- Taking full advantage of policy and regulatory measures already available in current rules

Some utilities have developed a real-time “customer behavior analytics engine,” driven through a data warehouse, that greatly improves their ability to identify the most effective collections actions and to target specific customer segments and receivables.²

3. Transmission and distribution activities represent sources of both near-term cost reduction and cash improvement. Resources can be shifted and reduced by carefully looking at a variety of work tasks, from cutting staff dedicated to customer growth and new business (which the recession has temporarily rendered unnecessary) to more fundamental issues such as the level of resources dedicated to storm response.

For example, a number of utilities have made great strides in reducing the number of calls handled by

phone representatives by increasing customer use of IVR and the web.

4. Taking a hard look at shared services can lead to improvements in cost, cash flow, and invested capital metrics. We have consistently seen companies achieve near-term O&M expense reductions of between 5% and 30% and capital cost reductions of 5% to 15% in areas such as finance, legal, human resources, information technology, facilities, fleet, and supply chain and procurement.³ Rationalizing fleet size and deferring new vehicle purchases represent attractive untapped areas of cost reduction for many utilities.

5. Finally, there are a host of general expense opportunities that utilities can address, such as reducing spend for many initiatives and programs that are truly discretionary, streamlining back office and clerical support, and managing overtime tightly. For example, many “control-related” activities may not truly be requirements.

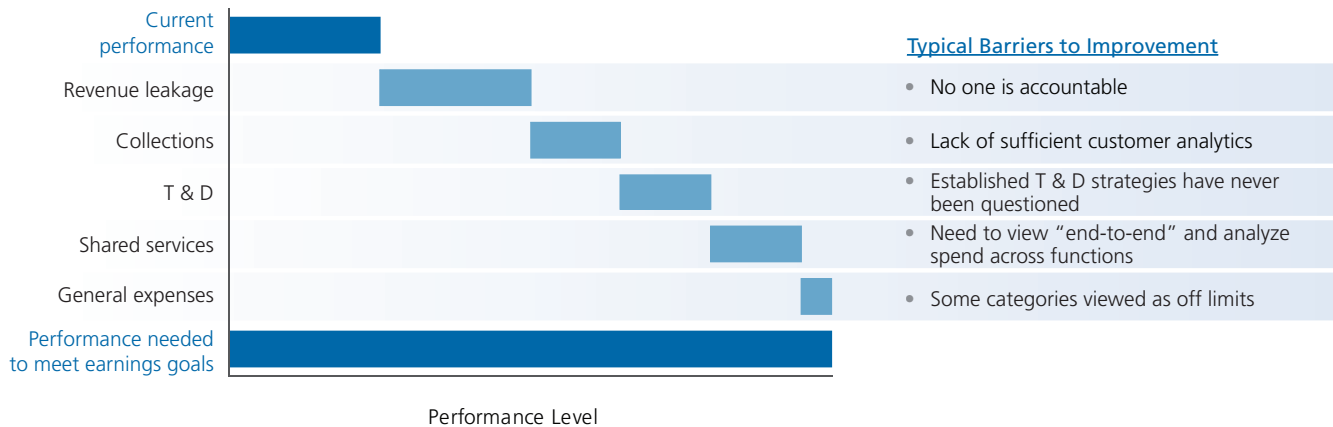
Exhibit 2 The five areas for utilities to focus on now

	Increase Revenue	Reduce Cost	Improve Working Capital/Cash Flow	Rationalize Investment
1. Revenue leakage <ul style="list-style-type: none"> • Pursuing throughput (kWh, Mcf) revenue leakage • Increasing non-throughput revenue • Accelerating rate case filings or targeted "special" riders 	● ● ●		● ● ●	
2. Customer care <ul style="list-style-type: none"> • Increasing collections activity • Reducing CSR-handled call volume 		● ●	● ●	
3. Transmission and distribution <ul style="list-style-type: none"> • Reducing new business staff • Reviewing storm response strategies 		● ●	● ●	
4. Shared services <ul style="list-style-type: none"> • Reducing corporate and shared services (administrative and general) expenses • Reducing assets and related expenses such as fleet, facilities, inventory • Conducting a procurement review to reduce the volume of purchases and improve pricing 		● ● ●	● ● ●	● ●
5. General expenses <ul style="list-style-type: none"> • Reducing "discretionary" expenditures • Streamlining back office and clerical support • Managing overtime tightly • Implementing wage reductions or freezes 		● ● ● ●	● ● ● ●	

² See “Managing in an Economic Downturn: Using Customer Behavior Analyses to Improve Bad-Debt Performance”

³ See “Driving A&G Savings through Results-Oriented Benchmarking”

Exhibit 3 Break through the organizational barriers



Staff layoffs are always sensitive and difficult for utility executives. And among the five areas of focus, some of the most beneficial measures, such as actions to reflect the big drop in new customer additions, may require reducing headcount. However, other actions, including steps to plug throughput-related revenue leakage, improve collections performance, and rationalize the vehicle fleet, may not require layoffs at all. In fact, these actions may cause utilities to add resources and create opportunities for employees with different skill sets.

Overcoming the Organizational Obstacles

In most cases, addressing the five areas will involve difficult discussions and choices. Revisiting assumptions will inevitably challenge the traditional ways of doing business. Utility executives will likely have to deal with several common obstacles, shown in Exhibit 3, in order to successfully implement these initiatives:

- *Revenue leakage is not typically on anyone's radar screen:* Addressing metered and non-metered revenue opportunities may be difficult initially, since no officer or function may be accountable for the full range of business activities.
- *Customer behavior analytics in the collections area do not exist.* Data access, analytical frameworks, and staff with the right quantitative skills must be

found within the organization or hired from outside. Quick hits depend on using proven methodologies and advanced analytical capabilities.

- *The thinking behind longstanding transmission and distribution strategies has not been challenged.* Reducing new business or storm response costs requires a willingness to fundamentally review and rethink the operating model.⁴
- *Spending for shared services occurs across the organization.* To see where the best opportunities lie, you need to take an "end-to-end" view of business processes and analyze spending across the company.
- *Many categories of general expenses are perceived as off limits.* Now the utility has to differentiate between expenses that are necessary for operations or for maintaining customer satisfaction and spending that is merely "nice-to-have."

The opportunities for improvement are real, and the obstacles to execution can be overcome. Utilities that pursue opportunities in these five areas can see rapid improvements to the bottom line and get back on the path to earnings growth. ❖

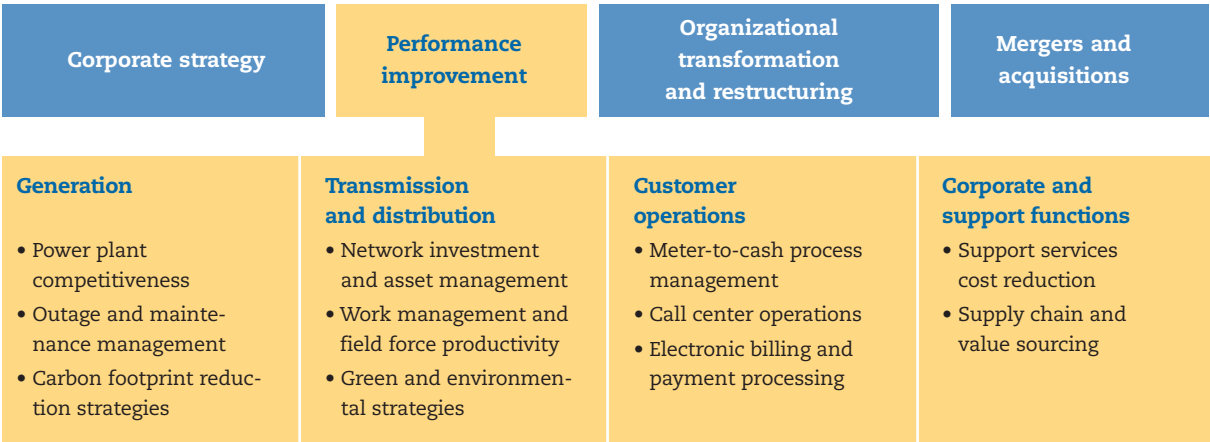
⁴ See "Rethinking the Distribution Operating Model: Targeting Resources and Work"

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David Hoffman
Practice Director
617.424.3414
david.hoffman@oliverwyman.com

Alan Feibelman
Performance Improvement
617.424.3405
alan.feibelman@oliverwyman.com

Gerry Yurkevich
Performance Improvement
617.424.3297
gerry.yurkevich@oliverwyman.com

www.oliverwyman.com