

A hand in a dark suit sleeve is shown in silhouette, moving a large black chess piece (a rook) across a chessboard. The background is a bright blue sky with a soft gradient. The chessboard and other pieces are blurred, creating a sense of depth and focus on the action.

Regulated Utilities

REINVENTING THE CLASSIC BUSINESS STRATEGY

Opportunities
and limitations
of five top
strategies.

BY DAVID FORNARI AND BRANKO TERZIC



Among the many fine books on strategy and value creation for the business enterprise, most are less than adequate for application to a regulated utility. Five classic approaches to value-creation and U.S.-style regulation of public utilities (electric and gas distribution companies) provide both limitations and opportunities when managements try to apply these approaches.

Of course, management at investor-owned utilities faces the same pressures in demonstrating creation of shareholder value as that of any other listed company. Management goals frequently are set in terms of higher-than-peer performance.

Boards reward managers based on such factors as superior share price appreciation and a track record of increasing reported returns on equity. The graphs on both of these performance parameters show a wide range of achievements (*see Figures 1 and 2, p. 47*). Thus, the stage is set for management to review strategic options periodically. So what are the best strategies available to corporate America?

Dr. Aneel G. Karnani, a professor of corporate strategy and international business at the University of Michigan, in a now famous *Financial Times* newspaper article, offered a brief but excellent synopsis of the best thinking about approaches available for value creation in strategy's intellectual circles,¹ discussing the advantages, disadvantages and difficulties surrounding each approach.

From a public utility point of view, the article was written for the "unregulated" company. The starting point of our discussion is the current position of a company predominately characterized as a "public utility." However, we recognize that almost no public utility company is restricted by law from entering another line of business. In addition, we accept Michael E. Porter's statement: "Competitive strategy is about being different. It is about choosing a different set of activities to deliver a unique mix of value."²

Thus, the real issue facing management is what set of activities should be undertaken to create value. Professor Karnani discusses five "possible growth directions" or methods of creating shareholder value. These can be described in five recognizable terms:

- Conglomerate – Unrelated Diversification;
- Vertical Integration;
- Synergy – Related Diversification;
- Globalization; and
- Market Penetration.

Managements may decide to pursue more than one "approach" at the same time.

What happens when these methods are applied to the regulated public utility?

Conglomerates: GE as the Ideal?

The Concise Dictionary of Business defines "conglomerate" as "a group of companies merged into one entity, although they are active in totally different fields." According to Karnani, the primary benefit of investment in totally different or "unrelated" businesses is the reduction of risk.

A conglomerate strategy assumes that investors would prefer management makes diversification decisions for the investor. The alternative is for the company to pay out a dividend, and for each individual investor to diversify his or her own portfolio.

For the regulated utility, the additional attraction of any diversification, related or unrelated, is frequently the lure of a higher nominal return on investment in the non-utility than that offered by the regulated business.

We do not offer an opinion as to whether this or any other approach is always, or even usually, successful. Karnani concludes that, in spite of the adulation and success of General Electric (GE) (and, we would add, of its former CEO), "the odds do not favor a strategy of unrelated diversification."

Recent examples include short-run stock price appreciation where unregulated companies and even some utilities have hit the diversification jackpot. This has been the case when the unrelated diversification has been in a particularly hot industry. Examples from the 1990s have seen utility stocks run-up based on investments in such trendy areas as the Internet, telecommunications, auctions, and fuel-cell technologies. The old adage says timing is everything, but given enough time, another old adage arises: "What goes up must come down."

The conglomerate form is no longer popular in the United States and Europe, but Karnani points out that it is the dominant form of organization in Japan, Asia, and Latin America. He ascribes this to "inefficient capital markets, the importance of political influence and a shortage of managerial talent." Arguably, these are not universally recognized attributes of the U.S. economy.

However, one knowledgeable observer, the late Joseph F. Brennan, a utility rate-of-return expert witness, once said that a version of the "inefficient capital markets" thesis was the only justification for an "unrelated" diversification strategy by regulated utilities. Brennan asserted that utilities could use their access to capital markets to finance the expansion of local emerging companies. To do this effectively, he observed, the incumbent utility management would need to acquire or develop the "core competency" of a successful venture capitalist. When asked how this could be done, he reflected, "Everything is possible, but not probable."

Even if a utility's management could convince its board of directors to permit a strategy of non-related diversification, there are regulatory risks. A regulated public utility could diver-

sify directly by acquiring non-regulated unrelated subsidiaries. It also could create a holding company and diversify away from the utility. In both cases, a reasonable regulator will be watchful to ensure that the diversification does not increase the cost of capital to the utility, add risk to the utility, or transfer any inappropriate costs to the utility.

For these reasons a utility management team runs a regulatory risk when it decides to diversify investments.

An unreasonable regulator could try to confiscate earnings of the unregulated operations by transferring utility costs to the unregulated operations through inappropriate allocation mechanisms. One common method is to charge the lower of costs or fair value for items purchased by the utility from affiliates but to charge non-utility affiliates the greater of cost or market for items provided by the utility. This is known as “asymmetric pricing.” Similar negative actions are the regulator’s invention of “royalty” charges to the unregulated operations for the use of the utility’s “goodwill.”

Public service commission staff or consumer advocates file rate-case testimony against the interests of the shareholders in diversified utility companies. Additionally, however, competitors to the utility’s unregulated business also use the regulatory process to try to handicap the utility. The competitive opposition even can orchestrate a legislative prohibition against utility investment in a particular line of business. Wisconsin, for example, passed statutory restrictions in the mid-1980s on the diversification selections of utility holding companies.

There always will be exceptions to every rule. Some unrelated diversification might emulate GE’s apparent success. However, the decision for the CEO and board of directors of any non-regulated company to diversify into unrelated business lines comes back to increased risk. Does the potential for a home run outweigh the risk of striking out? When it comes to creating value through diversification, the regulated utility company faces the additional risk of regulation. The regulator can tilt the playing field against the shareholder without any commensurate opportunity to see increased value achieved.

Vertical Integration: From Mine Mouth to Meter?

The value creation option of “vertical integration” is the movement to invest in either upstream or downstream assets, but such a move introduces new regulatory regimes, alternative outsourcing issues, and the response from existing regulation.

Going upstream or downstream could lead to investment in a business subject to additional regulation by another regulatory agency. The repeal of the Public Utility Holding Company Act by the Energy Policy Act of 2005 allows more options when it comes to utilities in one sector and geography investing upstream or downstream in regulated utilities in another

sector or geography.

Natural-gas distribution companies considering a move upstream could invest in a natural-gas pipeline. In that case, the state-regulated local gas distribution companies would own an investment in a business fully regulated by the Federal Energy Regulatory Commission (FERC).

This is the position that Wisconsin electric utilities face in their ownership of the American Transmission Co. (ATC). However, in this case ATC was created by the spinoff of transmission assets from the utility rate base. The state-regulated electric utilities now own a share of an electric utility subject to regulation by FERC as well.

The same situation faces a federally regulated natural-gas pipeline investing in electric or gas distribution assets or wholesale power generators investing in electric distribution facilities. Both Enron (initially a gas pipeline company) and AES (a wholesale generator), for example, bought state-regulated electric utilities.

Similarly, pipeline companies or electric and gas distribution systems investing in wholesale power generation will find that FERC has regulatory authority over the new investment.

Investments further upstream into natural-gas production, coal mining, or transportation systems also are possible and have been made by a few utilities. The acquiring board’s decision, when reviewing the possible move upstream, is whether the efficiencies gained by upstream integration are greater than those available from outsourcing these activities.

One possible downstream integration move is to invest in companies that provide services on the customer side of the meter. (This assumes that the market territory includes the utility franchise area. When this type of service is offered outside of the utility franchise area it is considered a move toward related diversification.) A typical investment for a distribution gas or electric utility of this type would be a move into the heating, ventilating, and air conditioning (HVAC) services or construction business. A number of state regulators have imposed “royalty” payments for the use of the utility’s “goodwill” in this kind of investment, and at least one state has issued an order prohibiting the utility from offering these competitive services in its own service territory.

These actions also raise the question of whether the regulator will move to capture actual or even imputed efficiencies (beyond the issue of royalties) in any upstream or downstream investment for the customers. The authority for regulatory action will come from the regulator’s well-established track record and legal authority under “affiliated interest” laws and rules. Some of these laws require significant intrusion into these relationships to include pre-approval of contracts and prices for services provided by the affiliate.

Thus, a move upstream or downstream by the regulated utility may involve questions about the desirability of acquiring a business under an additional regulatory authority. This option also raises questions as to whether the move is superior to the continuation of outsourcing the service, possibly with a new and more efficient provider. Finally, any move by the regulated utility to invest in a business where the utility itself may be the upstream or downstream customer could trigger the full authority of the utility's regulator under "affiliate interest" laws and regulations.

Synergy: The Holy Grail of Mergers

Mark Sirower defines synergy as "increases in competitiveness and resulting cash flows beyond what the two companies are expected to accomplish independently."³ These expectations of "synergy creation" lead to many mergers and acquisitions. However, he and many other analysts report that few mergers or acquisitions "create" value; more often, they destroy it.

Nevertheless, new acquisitions and mergers continue to be announced.

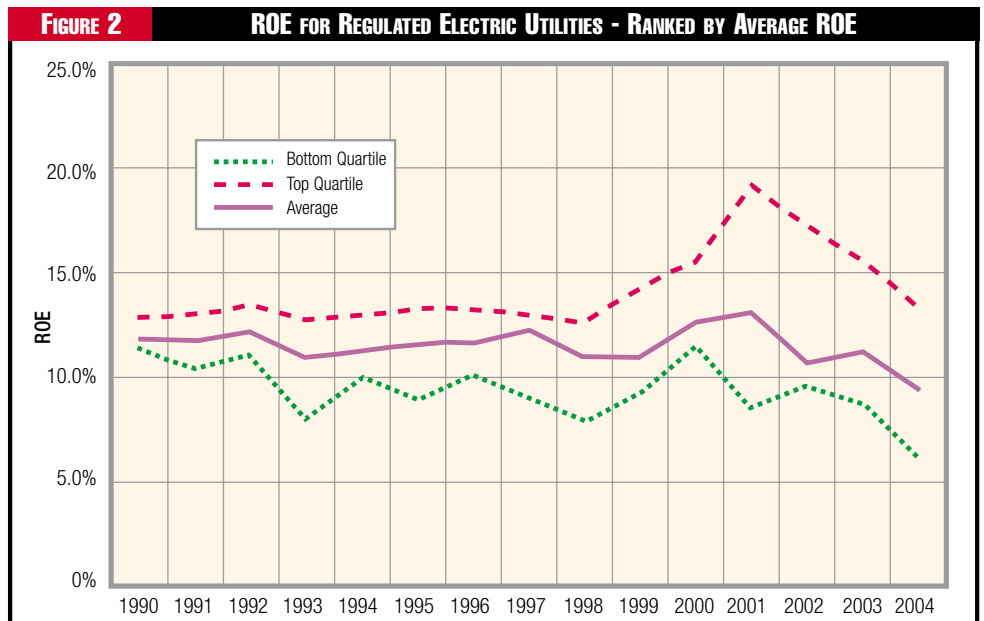
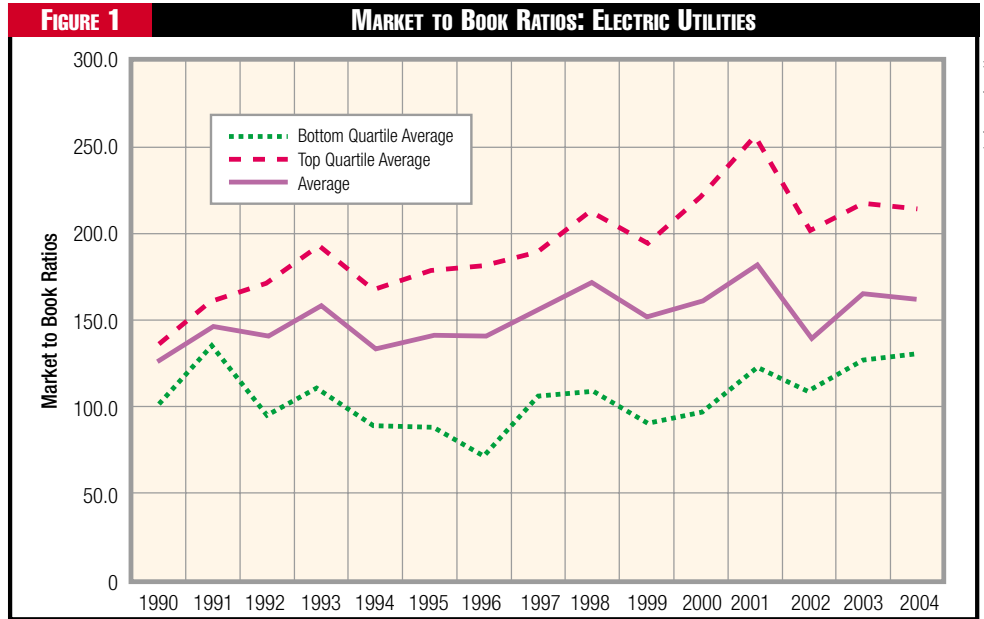
Acknowledging that few mergers are truly "mergers of equals" and that almost every merger is an acquisition with an "acquirer" and a "target," Peter Drucker, ever the realist, adds, "Acquisitions should be successful, but few are."⁴

The general procedure in a merger is that the respective CEOs meet to discuss the proposal, reach an agreement and finally gain approval from their boards and shareholders. The discussion between the two CEOs primarily is about how the benefits of the merger will be shared between the two companies. Both hope to gain benefits not otherwise available alone.

Warren Buffet characterizes this stage as that of a "princess" paying for the right "to kiss the toad" in the hope it will become a handsome prince.⁵ If the acquirer pays beyond what is reasonable for this right, the future is set up for failure if expected benefits (synergies) are not experienced. This sequence is followed by all mergers.

Regulated utilities face the additional barriers (sometimes multiple and usually contentious) of another sequence of negotiations. This time the two CEOs, after obtaining approval from their shareholders, must next negotiate with their respective state regulatory commissions and with FERC.

In the first round of negotiations, the benefits of the merger



result in the agreement to pay the shareholders of the company to be acquired. In the second round, the regulators determine how much of the remaining benefits of the proposed acquisition or merger need to be allocated to the customers of the utility to meet a “public interest” or harsher “public benefit” standard. (Regulators signaled long ago that the easiest way an acquirer can show a public benefit from a proposed merger is to have the approval result in an immediate rate decrease. There are other ways to meet the public interest standard—increased service quality, introduction of new technologies, and pre-empted future rate increases—but rate decreases are usually sure-fire.)

Thus, the synergy strategies via mergers, while available to the regulated utility, also include an additional set of critical negotiations and risks that must be considered to ensure enough benefits to go around.

Globalization: The British Are Coming

In the retail, manufacturing, financial, and professional services industries, the main growth strategy has been the pursuit of “global” markets. Corporate strategists teach that global expansion allows a company to exploit economic scale, technological edge, and marketing and brand-name advantages and expertise.

During the 1990s and continuing into this century, a number of regulated electric and water utilities also have made acquisitions of regulated public utilities in foreign countries. Utilities based in the United States have invested in Europe, Latin America, Asia, Australia, and China. European utilities, based in the UK and Germany, have made acquisitions in the United States. The UK’s Scottish Power acquisition of PacificCorp, the National Grid acquisition of the New England Electric System, and Germany’s RWE acquisition of The American Water Works System are the most prominent inward investment examples. A number of U.S. utilities, such as American Electric Power and TXU, acquired regional electric utilities in the UK.

At the time of their international acquisitions, the U.S.-based utilities had 100 years of experience as private corporations operating under independent regulatory agencies at the state and federal level. Retail rate regulation in the United States predominately has been under a “cost-of-service” (also called

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“rate of return”) ratemaking model. The western European utilities, when they acquired utilities in the United States, had a decade or so of experience operating in restructured environments (with separated electric generation, transmission, and distribution) and had more experience with a competitive wholesale power market. UK utilities also had experience under the more modern “price cap” (CPI-X) or “incentive” rate-making model.

At this point in time, the United States utilities have divested their UK utility investments, and Scottish Power has agreed to sell PacificCorp. The Scottish Power decision follows the failure of Western states to embrace restructuring and “incentive rates” and

problems in the western U.S. wholesale power market triggered by the failed California market experiment. The U.S. utilities’ decision to leave the UK followed problems in the UK’s wholesale electric market and a much larger than expected “windfall profits” tax as a new Labor government came to power and fulfilled one of its campaign pledges.

Thus, both U.S. and UK firms believed they had “core competencies” and “managerial advantages” in their acquisitions across international borders. In both cases, it was recognized that the ability to manage under regulation was the most critical “core competency” for successful management. U.S. firms entering England believed that their experience operating investor-owned utilities under public service commission (PSC) regulation in the United States would be a managerial advantage in the UK. The UK firms believed that their advantage in their more recent experience was purchasing in wholesale power markets and managing retail operations under “price caps” and “incentive rates.” In both cases management learned a tough lesson.

Professor Aneel G. Karnani observed that “to succeed at globalization, a company should balance global leverage with local adaptation.” Reflecting on Karnani’s advice, the case for any significant “global leverage” (in the sense of lower manufacturing costs) for a network-based utility is problematic. The ability of utility management to “adapt” to local conditions is critical. The primary local “condition” of concern here is that of “regulation.” In this case, “regulation” refers to the entire governmental scheme, including the executive, legislative, and administrative branches of government.

The key question for considering “globalization” as a strat-

egy for a company operating in the regulated utility industry has to be whether management from country “A” can successfully develop the new “core competency” to manage under the full regulatory scheme in country “B”?

Market Penetration: How to Sell More Product

For the non-utility, increasing market share seems the most likely of approaches to increasing long-term profitability. Among techniques frequently implemented for increasing market share are new product innovations, finding new market niches, consolidating the industry, and creating entirely new ways of doing business. Karnani writes that market share can be increased when a company invents “a new way of doing business, a new business model.”

Electric and gas distribution utilities have little access to most of these techniques due to a combination of franchised service territory, regulatory constraints on service quality, and capital expenditure approvals (or pre-approvals) for any new investment. Public utilities also operate under the condition that state regulators set their prices.

In some states the initiative to restructure the electric industry into components of separated electric power generation, transmission and distribution came from utility management and has the potential to establish a new business model. This type of restructuring involves a form of regulatory arbitrage. This is explained as power plants in state rate base (state public service commission-regulated as to profitability) becoming subject to U.S. FERC regulation when they are sold. The ability to obtain FERC-approved “market-based” pricing provides, under the right conditions, an opportunity to earn a higher return for better operating performance than continuation under state regulation.

The “market share” approach of “new market niches” has some direct validity in the case of distribution gas utilities in areas where fuel oil is a major competitor for space heating uses (predominately New England). The constraint may be the ability of the regulated gas company to obtain regulatory approvals for sufficient marketing, pricing and other incentives.

The “economies of scale” or “consolidation” approach is available. However, for systems of adjacent networks (electric) or overlapping networks (an electric distribution and gas distribution serving the same geography), the cost savings may not be as great as expected. The regulator also may transfer an

excessive portion of the certain savings to the consumer through the ratemaking process.

Successful industry consolidation thus becomes dependent on favorable regulatory treatment of the initial set rates and requires continuing favorable treatment going forward. As utility systems consolidate across state lines they pick up more regulators, increasing the regulatory complexity. However, the consolidation also diminishes the effects of positive and negative regulatory impacts on the larger consolidated entity.

A consolidated utility operation may be able to take advantage of greater purchasing power, shared joint facilities, and financing leverage. However, as in the other approaches, the ability of utility management to successfully negotiate the necessary regulatory processes is a paramount condition for success.

In summary, while in theory all five approaches (Conglomerate, Vertical Integration, Synergy, Globalization, and Market Penetration) are available to the regulated firm, in practice each approach brings different regulatory risks associated with current policies of individual state regulatory commissions or FERC. Once again, the core managerial competency of “management under regulation” may be the decisive factor in whether any of the five approaches to value creation can be successfully implemented by the regulated firm. A management not successful in operating the core regulated business has little chance of success outside of regulation. ■

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Adapted from a series of articles that first ran in New Power Executive, a publication of the Scudder Publishing Group LLC. Reprinted with permission of the publisher.

Endnotes

1. “Five Ways To Grow the Market and Create Value,” published on Oct. 18, 1999, and part of the *Financial Times* “Mastering Strategy” series.
2. Michael E. Porter “What Is Strategy,” *Harvard Business Review*, November – December 1996
3. Mark Sirower, *The Synergy Trap*.
4. Peter Drucker, “Six Rules of Successful Acquisition,” *Frontiers of Management*.
5. See Buffet’s 1981 *Berkshire Hathaway Annual Report*.



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