Conserving costs, powering growth

Rebuild the service company operating model

The power and utilities industry, long known for stable, predictable earnings, has become more volatile. There are a variety of factors at work, but the core challenges are simple: costs are rising, revenues are falling, and neither public utility commissions (for regulated operations) nor commodity markets (for merchants) are offering relief. Given a soft economy and the impact from shale gas, these trends are likely to continue for the foreseeable future.

For regulated utilities, the classic business model — grow earnings through rate increases — is struggling. Utilities are getting significantly less than they ask for in rate requests; in some cases, those requests are further burdened by declines in allowed returns on equity (ROEs). At the same time, electricity demand is down. The decline in demand caused by a stagnant economy is likely to reverse itself; the decline caused by conservation and increased energy efficiency is not. And finally, the flood of shale onto the natural gas market has permanently shifted wholesale prices. Severely depressed wholesale power prices mean sharply reduced earnings.

Companies are faced with a stark choice: cut costs or suffer the consequences. The question is where to begin. The value chain presents a variety of opportunities, but service company costs are a good first bet. In many instances, shared services costs for functions such as finance, insurance, IT, supply chain, accounting, legal and HR are increasing two to three times as quickly as operations and maintenance (O&M) expenses in the line business units. Further, these cost increases tend to crowd out the value in sorely needed capital investments, like infrastructure replacement, as service company allocations to capital projects escalate.
What’s the issue?

Service company costs for support services in the energy utilities sector have not historically been line-of-sight with customer rates or market prices. Such costs have traditionally been allocated across business lines in one-size-fits-all manner, and the result has been lack of transparency between general and administrative costs and end product costs. This means service costs have been difficult to predict and harder to control. In a fundamental shift, many energy companies are interested in more tailored allocations that better reflect each business’s need and profit opportunity — for example, allocating costs to a transmission line with Federal Energy Regulatory Commission incentive rates versus to a merchant super-critical coal plant.

This blanket approach wasn’t such a concern in the past, when rate cases were more reliably granted and/or wholesale prices offered plenty of margin. No more. In a tough economy, public utility commissions don’t want to inflict further pain on consumers. In fact, regulators are increasingly considering significant reductions in ROEs. In wholesale markets, natural gas forward prices show few signs of strengthening. Not only is there no relief in sight, the situation might get worse.

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Rate cases are up and returns are down

Source: SNL Financial/Regulatory Research Assoc. and EEI Rate Department
Why now?

Weakened revenues don't stop the need for investment. The industry is in a build-out cycle – with eroding infrastructure and rising new technologies, more investment is needed today than at any time since the nuclear build-out of the mid-1980s. Meanwhile, operating expenses are accelerating. If revenue isn't going to rise, costs must fall or earnings will be sacrificed.

Systemic change is required. The support services operating model needs to be revamped.

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**Top 10 general and administrative cost increases**

Three-year compound annual growth rate

1. Communication services (internal and external) 20%-30%
2. Security 20%-30%
3. Insurance 15%-20%
4. Legal 15%-18%
5. Corporate accounting 13%-15%
6. Environmental services 13%-15%
7. IT services 13%-15%
8. Safety 10%-12%
9. HR services 10%-12%
10. Business services 10%-12%

Source: Recent EY client assignments for power and utilities companies
How does it affect you?

There will always be a baseline demand for electricity, but the current situation is not sustainable. Companies that do not adjust to the new reality will suffer share price erosion and risk becoming part of the next wave of consolidation.

In many cases, the move to rethink the service company operating model is undergoing the second or third wave of cost takeout. The result overwhelmingly has been significant gains in productivity with limited operational risk.
What's the fix?

Utilities companies should focus on cost reduction across the service company. Tone from the top is essential – leadership should set appropriate goals and follow through to ensure execution.

Service organizations need to develop sustainable responses to their long-term cost challenges, implementing change at a structural level to fundamentally lower their cost basis. This calls for a systematic understanding of their costs to serve at a new level of granularity, as well as a disciplined approach to attacking costs. The service company is an excellent place to start because customer-facing activities can be protected.

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Here are five ways to move toward a next-generation support services model:

- **Segmenting the service company.** Leading service organizations are aligning service company costs to business segments and profits. As part of this seminal shift, businesses are taking a hard look at their cost allocation pools and scaling back those corporate services they cannot afford. For example, as generators shutter coal plants, what is the corresponding impact on shared services? As rate case increases are denied, what is the balance between reductions in the field versus the corporate center? In a low natural gas market, what is the overhead level or bearable burden that fossil fleets can handle?

- **Enhancing the line of sight between product and G&A costs.** Service companies have a fundamental opportunity to normalize their contribution and understand their fully loaded costs by unit of output (e.g., per customer, kilowatt-hour, megawatt-hour, megawatts of capacity). Companies should be able to see service company costs all the way through to the end-use market, as is the case of more mature sectors such as pharmaceuticals or big oil. This transparent view can be extremely revealing in terms of size of service company allocations and recent growth trends.

- **Embracing the idea of outsourcing.** Service organizations should look critically at each function: many in-house functions can be performed more efficiently and less expensively by third-party providers. The market for many functions, such as payroll or HR information systems, is mature, and the solutions proven. This issue calls for a fundamental rethink on the mission and role of the corporate center.

- **Revitalizing the organizational structure.** As the promotions pile up, talented, experienced senior management can end up in holding tanks for managers who don’t manage – becoming essentially high-paid subject matter experts. One way to address this is to redesign the management structure so that talent moves consistently toward the top – an "up or out" structure coupled with fewer levels and broader spans of control to ensure that management jobs are truly value for money.

- **Turning uncontrollable costs into controllable costs.** One example is the health and welfare expenses tied to an aging workforce. Leading companies are putting significant emphasis on keeping their workforces healthy and productive by implementing wellness measures such as regular health checks and easy access to workout facilities. As companies work to keep their costs in line, containing health and welfare expenses will test the traditional boundaries between employees and employers over such basic issues as preventative health care.
What's the bottom line?

It's time for power and utilities companies and their service organizations to engage in serious discussion around their operating models. Utilities should take a fresh look at capital and operating expenditures with an eye toward significant and sustainable cost reduction. (The mature cost optimization models of other industries can serve as useful examples.) Most important, making the most of every dollar — cost optimization — needs to become embedded in the culture. The service company, where costs are rising the fastest, is an excellent place to start.

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Want to learn more?

The answers in this issue are supplied by:

Dana Hanson
Power & Utilities Lead Americas
Ernst & Young LLP
+1 704 335 4210
dana.hanson@ey.com

Andy Patterson
Principal
Ernst & Young LLP
+1 404 433 4040
andy.patterson@ey.com

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You can contact us at:
fiveseries.team@ey.com

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