Of special interest to
Utility chief operating officers
Utility chief regulatory officers

5 Insights for executives

Most utility COOs are convinced their shared support services costs are sufficiently transparent

Are they mistaken?

The COO of a multistate electric utility faced a huge challenge: the company's current plan outlined capital expenditures that would translate into an annual rate increase for customers in the range of 4%–5% over the next five years. Increasing O&M costs would be on top of this asset-driven rate increase resulting in a double-digit rate increase across all jurisdictions. The regulators were going to be unhappy, but the COO felt sure the company could demonstrate the need for the investment and the validity of the O&M costs.

In an effort to avoid even greater rate increases, the company had initiated cost reduction efforts in support services areas (IT, finance, accounting, HR and legal) through a limited centralization or sharing strategy. The COO felt the regulatory team was doing a good job educating regulators and staff on shared support services allocations and methodologies.

But the COO had just gotten off a conference call with the General Counsel and the SVP of Regulatory Affairs. Settlement discussions with regulatory staff and interveners in connection with two ongoing general rate cases suggested that a significant portion of allocated support costs in both were being challenged and might be disallowed.

What was happening? How did efforts to reduce support costs become such a problem?

> "If a regulator doesn't understand the cost structure, the default position is disallowance."
>
> — Paul G. Afonso, Former Chairman of the Massachusetts Department of Public Utilities, Co-Chairman of the Energy, Utilities and Environmental practice at Brown Rudnick LLP

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1

What's the issue?

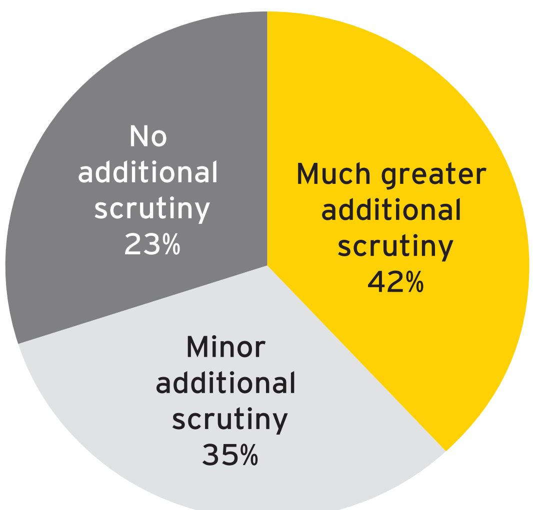
With the need to make significant capital expenditures each year for the foreseeable future, many utilities will also face the prospect of frequent filings for rate increases. In response, utilities can expect regulators to take all possible steps to mitigate the impact of these rate increases on customers. Utilities must find new ways to reduce support services costs further — but do so in a manner that readily responds to more intense regulatory scrutiny and a greater burden of proof.

Increasingly, regulators will ask utilities to provide even more rigorous justification of all operating expenses and capital investment decisions before allowing recovery through increased rates. In particular, they will target costs associated with A&G support (e.g., IT, HR, finance, logistics, facilities and legal) provided by centralized corporate functions via a shared services delivery model. Methodologies for allocating costs associated with centralized support services will increasingly be challenged.

History shows that support services that do not "reside" with the local jurisdictional utility (and therefore, also provide jobs and positive impacts to that state's economy) are often contested and sometimes disallowed. This is the case especially when the regulator does not understand or agree with the allocation methodology. Yet, 65% of respondents to a recent EY survey believe their costs and allocations provided by a corporate service center and/or shared services group are "very transparent" to regulators.

"While respondents indicated their costs are transparent to regulators, it is our experience that many internal division leaders question the validity of shared service charges in their budgets" says Roy Ellis, leader of EY LLP's regulatory services for the utilities sector. "The value of those services are not transparent to them, which raises questions about how transparent they truly are to regulators."

Differing views of administrative and general expenses
In a recent EY survey, the majority of shared services providers believe their services account for 20%–40% of the administrative and general (A&G) expenses of the business. However, receivers of these services either don't know or estimate the services to account for about half of that amount, 10%–20% of the expenses.



To what extent will shared services costs be scrutinized by regulators in the future?
In our recent survey, almost 60% of respondents said they believe allocated costs associated with services provided by a corporate service center or shared services group will come under limited to no additional scrutiny by regulators.

Do you know what your costs are?

"If you really wanted to see what the costs were, it would be hard to answer that question. You have to sort of back up to get there."

Utility shared services receiver

"How much of the total corporate IT budget we happen to see or the HR department ... that's not something I can readily lay my hands on."

Utility shared services receiver

2

Why now?

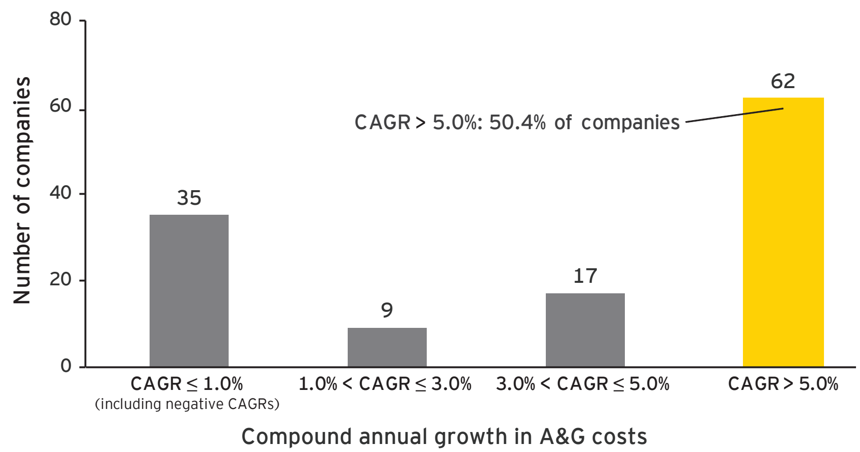
Massive utility capital investment requirements alone are expected to translate into annual rate increases in the 4%-5% range, along with additional rate increases as a result of higher operating expenses. This could translate into the possibility that utility customers will see electricity rate increases that annually approach or exceed double digits.

If regulators view some or all of the costs associated with support services provided by corporate-level functions as remote and removed from utility control (and also from direct regulatory scrutiny), the pass-through could be disallowed.

Despite service-level agreements between support groups and jurisdictional business units, annual cost creep of 3%-5% associated with support services is often the norm. Yet many utilities persist in downplaying the risk that regulators, with state budgets being frozen or reduced, will no longer allow the routine pass-through of increases in allocated support services. In fact, in our survey, almost 60% of respondents said they believe allocated costs associated with services provided by a corporate service center and/or shared services group will come under little to no additional scrutiny.

Cost trajectory for support services: looking back to predict the future
In EY's analysis of FERC filings from 2007–2010, about half of the companies showed an A&G expenses compounded annual growth rate of 5% or greater. Yet, in our recent survey, only half of the respondents said they believe that cost trajectories associated with support services will increase at a pace in line or faster than those associated with non-fuel O&M in generation and T&D.

Most companies have had increasing A&G expenses



Note: CAGR = compound annual growth rate. Results are normalized to MWh sales.

Source: SNL, EY analysis

Three reasons for challenges to cost recovery associated with support services

1. Support functions are often viewed as secondary in terms of importance when compared with operations areas (e.g., linemen responding to outages or operators that keep the power plants running). This makes it easier for regulators to question costs associated with "overhead" than those associated with energy delivery and power plant operations.
2. For the utility with multiple jurisdictions, support-services costs typically are assigned to a specific utility based on allocation percentages. These allocated costs often lack transparency and can provide an opportunity for regulatory scrutiny.
3. The costs of support services sometimes increase more rapidly than costs associated with energy delivery and power plant operations areas — and become bigger targets for regulatory scrutiny.

3

How does it affect you?

Whenever regulators disallow cost recovery, the impact goes directly to the utility's bottom line. This means that shareholders take the hit.

To the extent that rate increases are related to rising costs associated with support services, there will be additional pressure from regulators to moderate the impact on ratepayers. This could include:

- Reducing the allowed rate of return on common equity
- Phasing in rate increases
- Forcing utilities to agree to rate freezes or multiyear stay-out periods

These pressures could translate into negative shareholder value impact, lower returns and prospects for flat EPS growth.

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4

What's the fix?

The next-generation support services delivery model for the power and utilities sector.

There is no "one size fits all" when moving to a next-generation support services delivery model. Each organization needs to determine the best approach rather than just the traditional centralized support services model. The new model should:

- Capture the cost advantages of shared services
- Deliver improved value of services and control associated with decentralized
  support functions
- Pass regulatory scrutiny

The next-generation service delivery model aligns support service groups locally with operating companies but manages them through a matrix management structure. This delivery model incorporates traditional shared services elements to streamline and centrally perform routine transaction-oriented activities. It also captures economies of scale through common resources and infrastructure.

There is no "one size fits all" when moving to a next-generation support services delivery model. Each organization needs to determine the best approach rather than just the traditional centralized support services model.

Centers of Expertise: models for power and utilities transformation

Almost every utility has adopted some sort of shared-services model in connection with its A&G support areas. The key to transforming existing models and implementing a next-generation support services model in the power and utilities sector is found in the concept of centers of expertise (CoEs), which companies in many different industries have created in connection with skilled, as opposed to transactional, support functions.

CoEs use a variety of organizational designs to align decentralized and distributed-support resources under a single management structure. CoEs seek to improve the overall load factor of skilled resources and to tap into capabilities, insights and best practices that exist throughout the organization.

5

What's the bottom line?

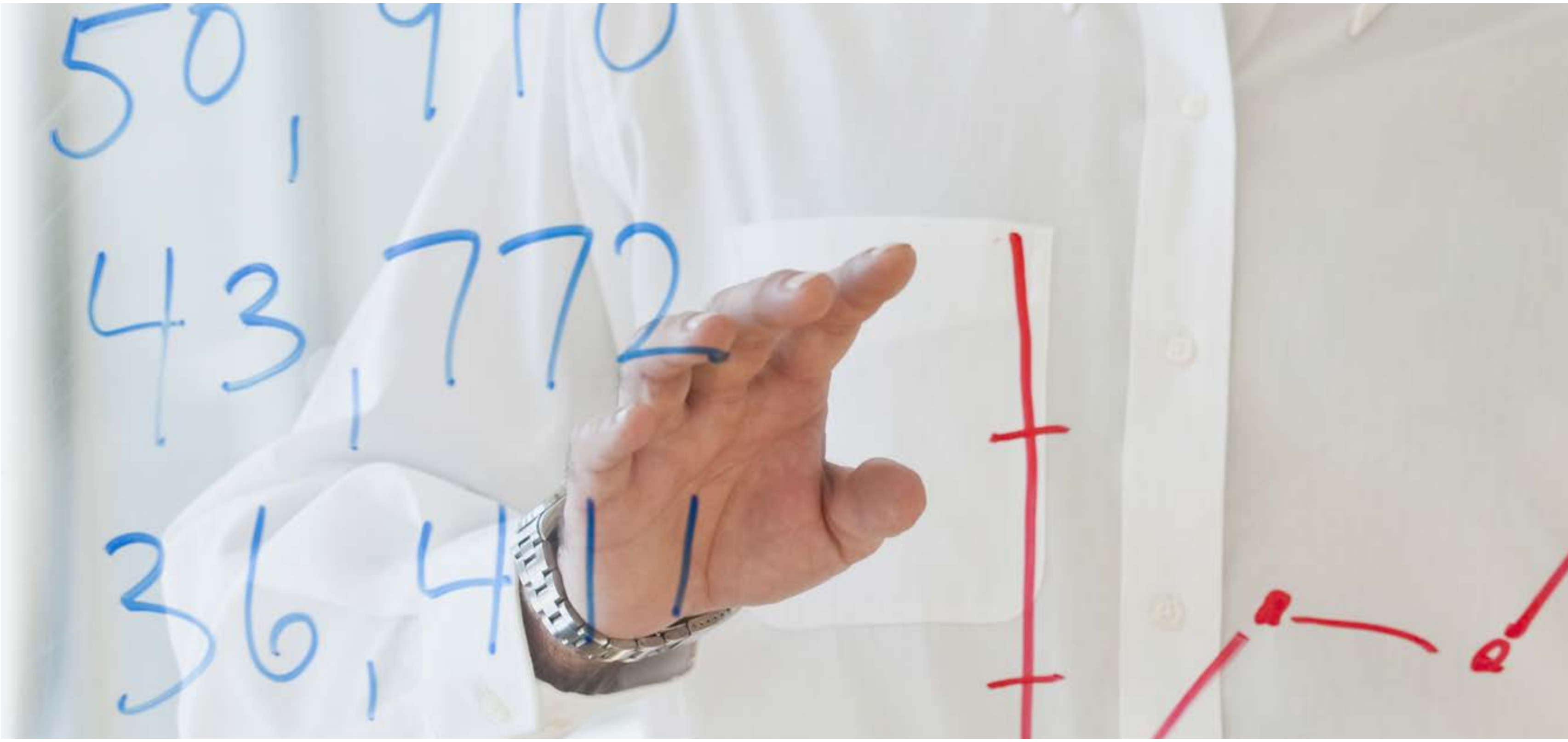
In view of the increasing scrutiny of costs by regulators, utilities cannot afford the possibility that rate increases will be denied due to a lack of transparency in their shared services. As we have pointed out, regulators will continue to ask utilities to provide more rigorous justification of operating expenses and capital investments before allowing recovery through increased rates. In particular, they will target costs associated with A&G support corporate functions via a shared services delivery model.

It is our view that utilities cannot assume that their shared services are sufficiently transparent to regulators to withstand challenges and possible denials of requested rate increases.

Utilities need to implement immediately a next-generation model that will:

- Improve transparency and defensibility of support service costs
- Increase the likelihood of cost recovery
- Augment overall utility returns

Not doing so can have drastic consequences.



Want to learn more?

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