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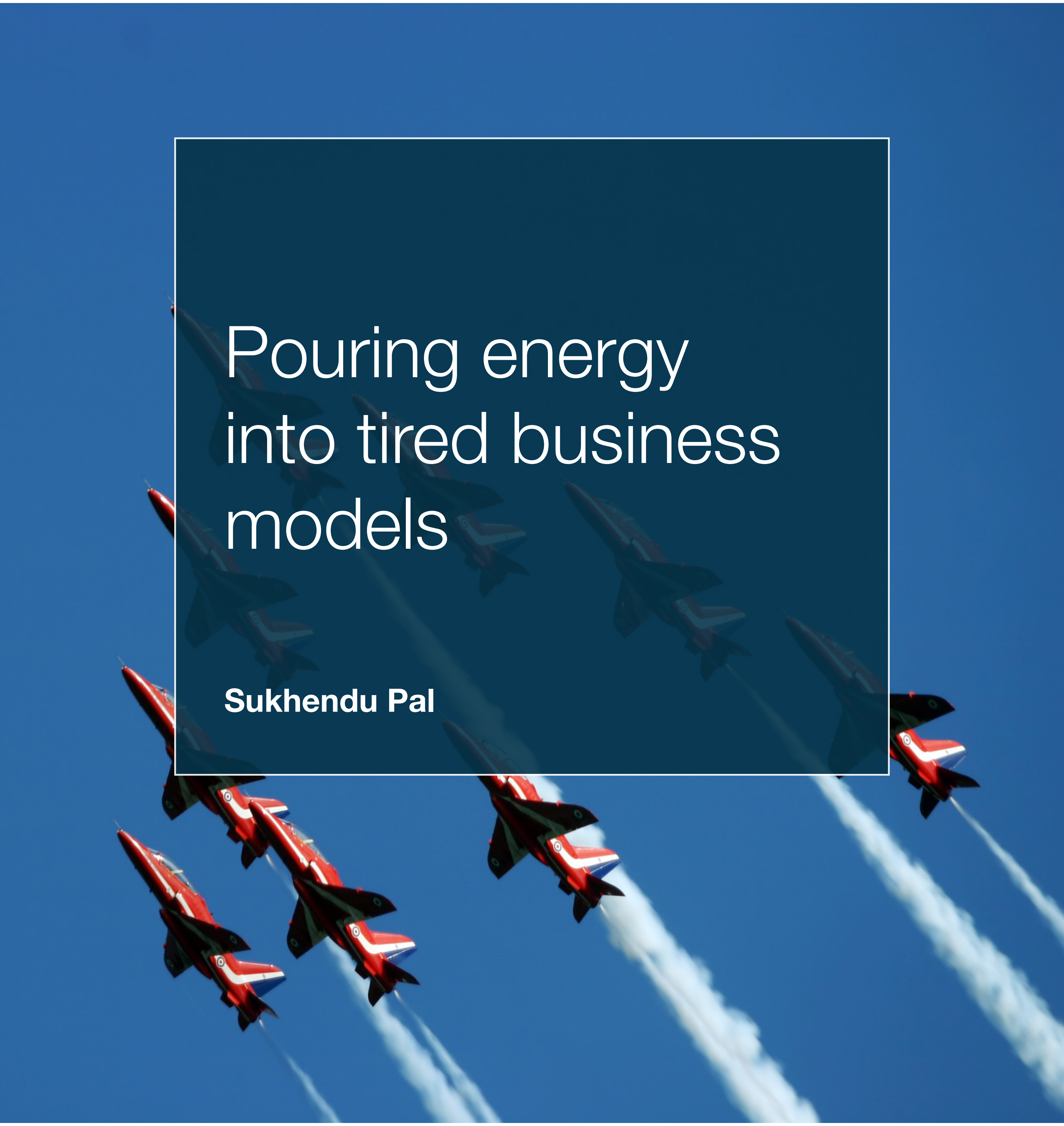

Pouring energy into tired business models

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Privatisation was one of the great achievements of the 1980s. But it is becoming increasingly evident that the transfer of monopolies into the hands of six regulated companies that own, run and develop the assets isn't working. This is excessively costly to customers. It is also an obstacle to investment in risky long-term assets such as nuclear power, electricity and gas networks. All energy companies' business models are similar: old and tired, and customers are paying for it. But it doesn't have to be a choice between heating or eating – there is a better way and that requires energy companies to reinvent their business model and outdated practices. And, this is how.

The recession has cut oil prices to less than half of their peak a year ago and has sent wholesale gas and electricity prices tumbling. Yet, the customers of both gas and electricity a pay higher price for similar consumption today. The UK gas and electricity prices have risen in real terms by 41% and 20% since 2007, and climate change policies, including a carbon tax on energy from coal and gas plants, will add to suppliers' costs, and could rise another 50% by 2020, while the average household income has risen only 3%. This is because the fall of oil prices has exposed an inflated cost base in most energy companies. Despite their usual attempt to reduce operating costs, rationalise investment budgets, and improve operational efficiency, very few energy companies have succeeded in making lasting cost cuttings. That is not surprising because many of these cost cutting programmes focus only on short-term expenditure leaving them exposed to costs rising in medium and long terms.

Today's unique combination of environmental initiatives, new technologies, need for secure energy supply, and economic constraints calls for decisiveness in redefining and improving the way European energy companies operate rather than just short term cost cutting initiatives. Every aspect of the energy business model is under siege today. The carbon reduction agenda and oil price volatility is putting pressure on companies to diversify generation portfolios, upgrade transmission networks, and engage with customers in ways that they have never done before (see Figure 1).

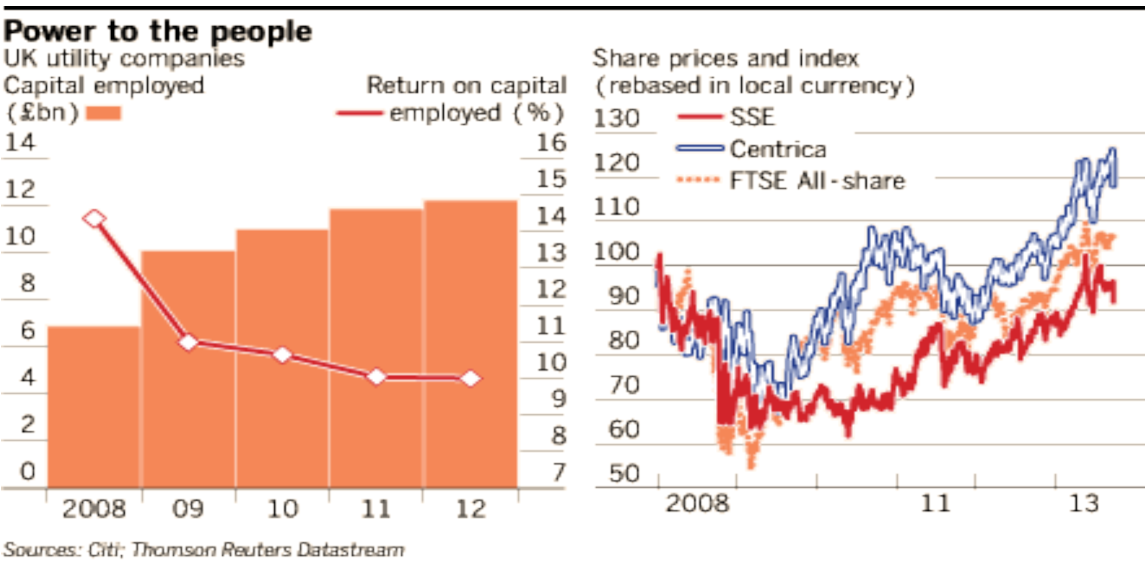


***Figure 1:** Every aspect of the energy business model is under siege*

Advanced technologies offer the prospect of an intelligent smart grid and workplace. Poor integration of value chain and autonomous independent business units doing their own things are keeping most senior energy executives awake at nights. Customers are more sophisticated than they ever have been – leaving one energy company for another for better services and price. And, talent requirements are changing as a fundamental generational shift occurs among the workforce.

Uncompetitive UK energy market breeds inefficiency

Since the energy market opened, 16 companies have entered under their own licence. Seven of these remain. This could be evidence of commercial brilliance. But no company without links to the period before liberalisation has been able to gain a foothold in the market. Incumbency seems to be a powerful weapon (see Figure 2).

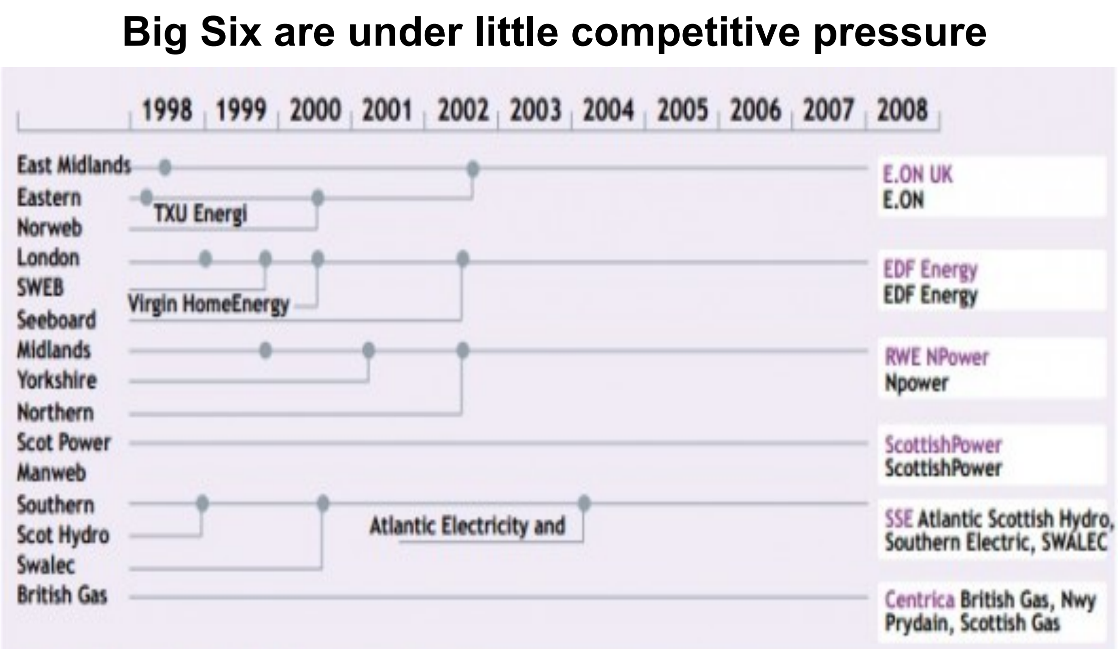
Herd-like pricing behaviour also suggests little worry about smaller, newer companies taking customers from the Big Six. Some competition is better than no competition, but more is essential. When taxes are excluded, the UK has some of the highest electricity prices in Europe, and is near the middle of the pack in terms of gas prices.

Trust deficit makes energy companies a villain

The uncomfortable truth is that the energy companies are not trusted today. They spend millions of pounds on public relations, advertising and sponsorships but they're still considered to be exploiting their market position to the detriment of the ordinary customers. These companies seem to have failed to notice that their customers live in an internet age in which power has shifted back to them. Customers are expected to be able to compare prices instantly and to be given information on every aspect of every transaction.

The consistent price increase regardless of market conditions made energy companies a villain. Major energy suppliers have all used the argument of mounting wholesale costs – which make up nearly half of household bills – to explain price increases. They have also blamed Government green schemes and rising network charges. However, the data from energy regulator Ofgem show wholesale prices have been almost flat over the past year, rising by a mere 1.7% (see Figure 3).

The Big Six energy companies in the UK argue that there is little they can do to avoid price increases. They suggest that the price increases reflect the costs of buying energy on the wholesale market, delivering it to homes, improving the



Source: Ofgem; Energy Supply Probe – Initial Findings Report (2008); Sirius & Company Analysis

Figure 2: *Little competitive pressure from new entrants*

network and the Government's green policies (see Figure 4). There are some truths in it, but it hides the inefficient ways most energy companies are run.

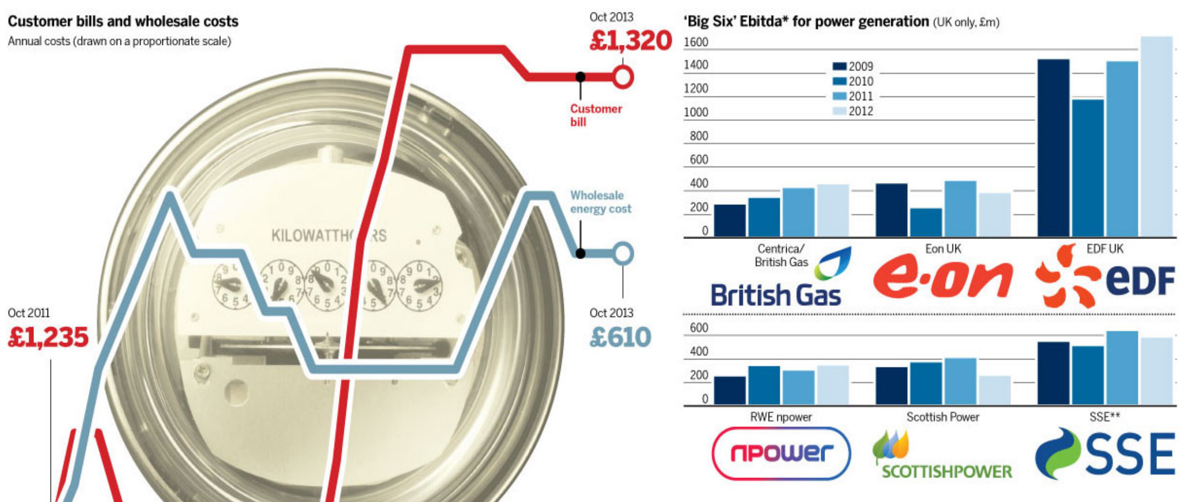
Customers legitimately ask: why can't the energy company (and indeed all their suppliers) produce a detailed breakdown of costs and charges, including margins? Why can't energy companies show why an increase is necessary rather than simply treating customers like children who wouldn't understand if they were told too much?

To the contrary, customers do understand basic economics. They understand prices and costs and the need for a reasonable profit margin to justify investment. The same message applies to the costs of new supplies. Total transparency is the only practical answer to the trust deficit. But perception is everything. If customers feel energy companies are not being straight with them they will be hostile, and out of hostility can flow all sorts of policies. Trust flows two ways, and it is time the energy companies started trusting the people who keep them in business.

Operating Model

Most energy companies' organisational models are remarkably consistent - excessive decentralisation and autonomy of business units - an almost complete devolution of decision-making rights to the operating business units. This type of organisational model has been espoused so often and with such conviction that one might even refer to it as the conventional wisdom. Like most conventional wisdom, however, this model does not always serve energy companies well, especially as they navigate ways to grow in uncertain markets. Consider the book written by Larry McDonald, a former bond trader at Lehman Brothers, on that bank's collapse. His main intention was to reveal the extraordinary ineptitude of the former Lehman bosses. In practice, though, his story highlighted another crucial problem that haunts the energy companies today: the curse of silos.

Since most energy companies have similar products, it will be the *innovation* and *integration* of the highly autonomous business units that will make the difference. The question most energy companies now face is not whether they need to be agile and efficient, but how can they integrate a diverse set of autonomous business units, who keep doing things their own ways, which increase complexities and unprecedented level of costs. We have found that responding effectively in uncertain markets requires more, not less, direction from the centre. Our work with other sectors suggest that, in industries undergoing rapid and unpredictable change, a Lean Corporate Centre must play an active and powerful role in coordinating business unit level activities and help to integrate companies along the value chains. What's more, to compete effectively as a company, it often falls to the CEO and a select group of

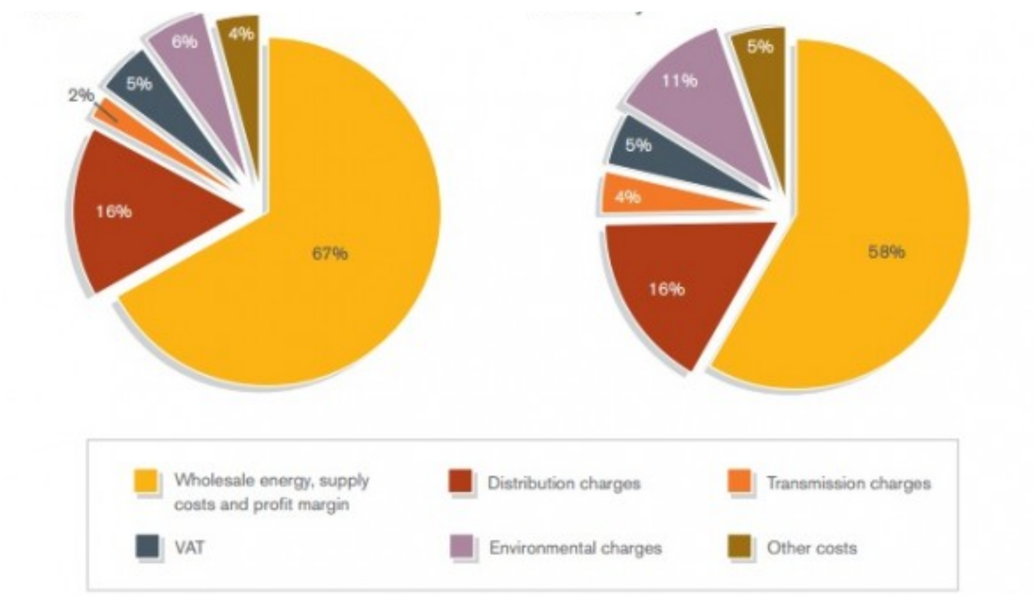


Ebitda* of the Aggregate Supply Business (UK only, £m)

	2009	2010	2011	2012
Centrica/BG	731	1,003	776	838
Eon UK	105	302	285	235
EDF UK	-22	92	4	-46
RWE npower	-122	14	119	267
Scottish Power	144	82	6	6
SSE**	208	370	256	327

* Earnings before interest, taxes, depreciation and amortisation ** SSE year end in March of the following year. Other figures refer to calendar years

Figure 3: *Wholesale prices have been almost flat over the past year*



Source: The Financial Times; Sirius & Company Analysis

Figure 4: *Sources of energy bill costs*

staff to drive the transformation and integration of efforts between business units – we call this group Lean Corporate Centre (LCC).

Customers today expect responsive product development, order fulfillment, service, and administrative backup. That requires an energy company's operations to be coordinated and internally transparent. Most energy companies' CEOs know this but frequently are deterred from accomplishing it by entrenched silo mentalities of the business units, a lack of executive courage, and the difficulty of identifying top notch talent internally for integration projects.

In response to the integration pressure, many energy companies have begun to change their organisational structures and operating models. Even where business units have traditionally been highly autonomous, energy companies are finding that they need to institute horizontal processes and shared services to improve operational efficiency, maximise talent and expertise, and raise the level of customer service, particularly where markets overlap. By definition, this can be neither led nor facilitated from any one silo. It requires a corporate mechanism that can overcome traditional silo resistance through its mandate and capabilities. That's the work of an LCC. By developing a better operating model (see Figure 5), energy companies bring together the way customer, people, processes, technology, organisational structure and ownership interact to deliver performance based on highest skills that their competitors can only envy. The leading energy companies can capture significant benefits by rethinking all the components of the operating model, compared with laggard energy companies that focus on only one or two components. To grow their business, CEOs of energy companies need to unashamedly reinvent their organisations from shareholder-centric to customer-centric. This is because, loyal and profitable customers are invaluable to serve the interest of shareholders and not the other way round. They will need to drive their companies to innovate products and services that serve customers' true needs. It is essential for the CEOs to recognise that poor practices that only benefit energy companies at the expense of customer inconvenience in the current recession and irritations are not going to help build customer loyalty. The energy companies of the future will be radically different from the current ones (see Figure 6). They will be integrated along the value chain yet agile, more performance oriented and technically diverse, leaner and lasting.

They will abandon the traditionally old and tired business model in favour of companies that align and support their distinctive operating strategies. This will create an agile and internally integrated organisation that effectively blends assets and capabilities with the ability to anticipate and quickly respond to changing priorities of the marketplace. Demanding customers, together with the tough economic conditions, will accelerate the transformation of poor customer services found in most energy companies today. Even today, most energy companies treat their customers in a similar way with largely undifferentiated services, delivered via a limited number of channels. The customer services of tomorrow's successful energy companies will be similar to retail or mobile telephone operators.

There are important and legitimate reasons for energy companies' products to be aggregated into service bundles or packages. The logic comes from economics. Cost sharing in the production or delivery process can make providing a service bundle more efficient than providing individual products. For example, when a customer adopts online payment, energy companies could use this electronic link to their customers to introduce new service bundles at lower cost.

Develop a service culture

Delivering services to customers will be a challenging task for most energy companies, since their operations exist in functional silos. In future, instead of providing electricity and gas to customers, they have to become *service makers*. In this operating model, customers describe what services they want, where and how they want them and energy companies deliver them, without compromise or delay. The role of the customer in this operating model shifts from passive recipient of connections to active shaper of customised services. This increasing dominance of customer choice means energy companies must restructure generation, trading, transmission and distribution, retailing, sales and customer relationship processes and IT applications and IT infrastructures. Once an energy company has gained this increased control over its relationships with its customers and made this cultural shift, it can use its store of customer information to expand into adjacent markets. It is clear that the victors will be those energy companies with the best-designed service aggregation capabilities, the most responsive networks of partners in the value chain, and the closest customer relationships.

What does this mean for energy companies?

Banks and utilities have got nowhere by protesting that they are being unfairly scrutinised. People who have suffered since the 2008 financial crisis have no time for complaints from enterprises they distrust. The banks' legitimacy problem related not to prices but the taxpayer support they received in the 2008 crisis. Most people, legitimately, do not think it was fair for bankers to be rescued from their own folly in this way.

So what should these companies do? *First,* they should carry on making their case in a way that is open and honest. *Second,* they should be more open. Banks and utilities often profit from opacity in how they trade and price products. Banks favour over the counter derivatives to exchange

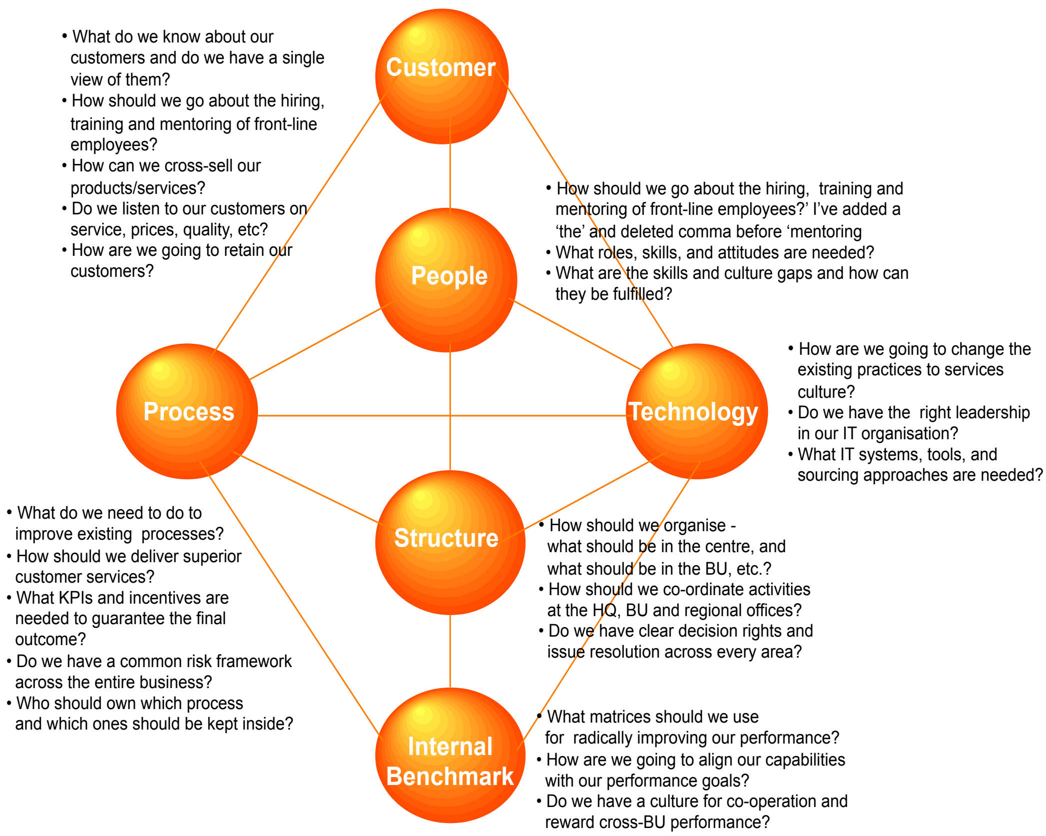
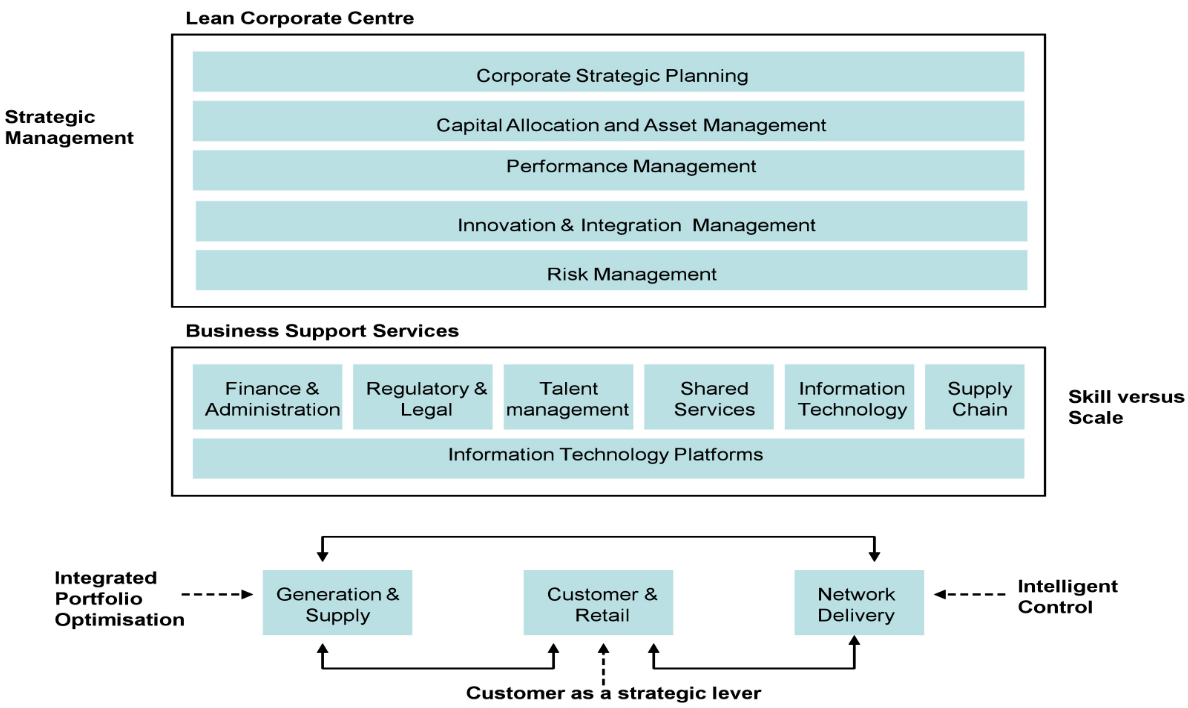


Figure 5: *New Operating Model*



New Business Model for Energy Companies

Figure 6: *New business model*

traded contracts; energy companies devise complex tariffs that make it hard for their customers to compare them easily. If energy companies have nothing to hide, they should not resist the total transparency of their pricing models. *Third,* they must endure. Energy companies will be in the maelstrom for some time but no one wants to make their business impossible. *Finally,* energy companies need to reinvent their old business model, abandon poor practices, and adopt the new business model described earlier.

In order to succeed, energy companies will need to rethink how they manage risk and make investment decisions, and how the elements in their portfolios fit together to create stakeholder value. Operational excellence, technological innovation and strategic cost leadership are going to be essential. Doing one or two things well will no longer be sufficient to generate acceptable returns for shareholders or sensible pricing for customers. Successful energy companies must develop expertise across the value chain.

And, the role of LCC has cascading effects on how energy executives manage the company that effectively blends assets and capabilities with the ability to anticipate and quickly respond to changing priorities of the marketplace. As the energy companies evolve from traditional assets-based and decentralised business unit-centric operations to highly intelligent automation with superior and differentiated customer services, they will embrace LCC and will be highly performance-orientated, and the laggards will continue to operate in the traditional manner and will eventually be acquired.

About the author
Sukhendu Pal is the CEO and Managing Partner of Sirius & Company.