

# Strategic Asset Management: an Earnings Growth Driver in the Energy Delivery Business

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The capital markets are demanding a new, higher level of financial performance from the once-sleepy electric and gas utilities. The combination of new risks associated with changing regulatory regimes and Wall Street's natural reward for successful growth companies has created an imperative for utilities to grow earnings in a sustainable way. These forces have created a significant challenge for companies in a mature industry whose product demand is closely tied to GNP and natural population growth.

Unfortunately, these new challenges arise at a time when corporate strategy in many electric utilities is in a state of gridlock. The failure of the California "deregulation" process, combined with the aborted merger initiatives typified by FPL/Entergy, Sierra/PGE, and ConEd/Northeast, have stymied many enterprise-level efforts to create truly competitive businesses, to build new economies of scale, or to materially increase earning growth rates in the core business. In short, U.S.-based, investor-owned electric and gas utilities are asking simply, "OK, what now?"

The answer for the energy delivery business lies in a new business model for electric and gas transmission and distribution known as strategic asset management. At its core, it provides an innovation-driven opportunity for cost reduction that will benefit all energy consumers. As a management tool, it provides a change catalyst that will enable firms to quickly rationalize resources and improve returns.

Most importantly, as a growth opportunity, it provides world-class operators who have growth aspirations with breakout strategies to achieve earning growth rates 3-5 times greater than their natural 2-3 percent growth.

## What is Strategic Asset Management?

Strategic asset management is a business model taken from other asset-intensive industries (the real estate and airline industries are notable examples) and it is already demonstrating early success in the U.K. and Australia/New Zealand energy delivery markets. It purposefully breaks down the notion of the integrated energy delivery system by separating the responsibility, resources and even the capital associated with "owning the system assets" (title to utility property, responsibility to shareholders, managing the customer and regulatory franchise, etc.) from the activities related to "managing and optimizing the system assets" (the decisions about where,



when, and how to build and maintain the delivery system of wires and pipes). It also separates out the routine labor activities related to daily system operations (operating the system, reading meters, responding to customer requests or outages, etc.). Figure 1 illustrates the conceptual decomposition of major business activities and processes.

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In the early stages of evolution, companies that have adopted the strategic asset management business model see it first as a catalyst for organizational change and cost reduction. The effort to separate and scrutinize these distinct activities inside an energy delivery company highlights previously undetected or unmanageable inefficiencies and misallocations of resources.

It allows them to more easily compare internal costs to competitive alternatives on the market. Thus, at the early stages, strategic asset management is seen as the natural "next step" or successor to achieving further operational benefits on the heels of the ubiquitous "process reengineering" efforts of the 1990s.

The few U.S.-based utility systems that have adopted

the strategic asset management model are generally in this early evolutionary stage. Figure 2 highlights the phases we have seen energy delivery systems evolve through on their path to achieving world-class performance.

This strategic asset management model has enabled energy delivery companies to identify those business functions or processes (energy network services, IT infrastructure, etc.) where they have achieved world-class level performance in order to develop targeted business offerings to the market. Early initiatives in the UK and Australian markets are receiving highly favorable responses from both regulators and the capital markets.

The initial force behind strategic asset management is the concept of universal contestability, where in the long run many utility-related services will be competitively bid. Simply stated, it means "do what you do best and outsource the rest." In short, many business activities will be competitively supplied from the market rather than satisfied by a utility's internal, dedicated, and often sub-optimal workforce and work practices.

The utility as we know it today in effect becomes the market maker and integrator that assures that services are supplied by the best and least-cost providers. Although this is an idealized concept, it is also an obvious long-run direction for the industry.

Indeed, in the more mature electric energy markets in the UK and Australia, the concept of universal contestability has gained wide-scale acceptance by regulators as an excellent way to assure least-cost service and by the

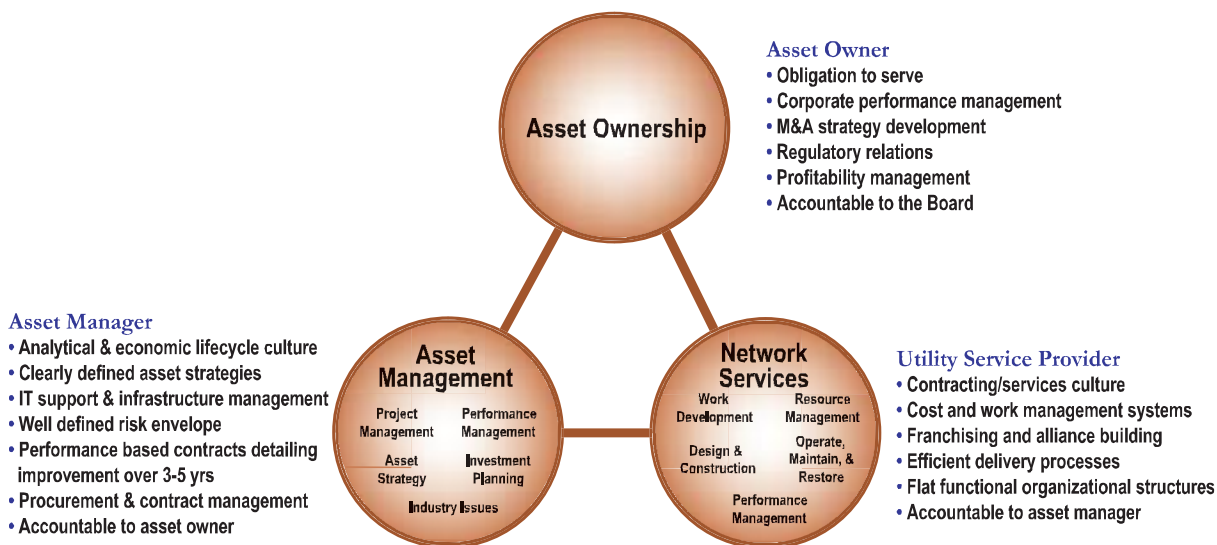


Figure 1: Strategic asset management framework

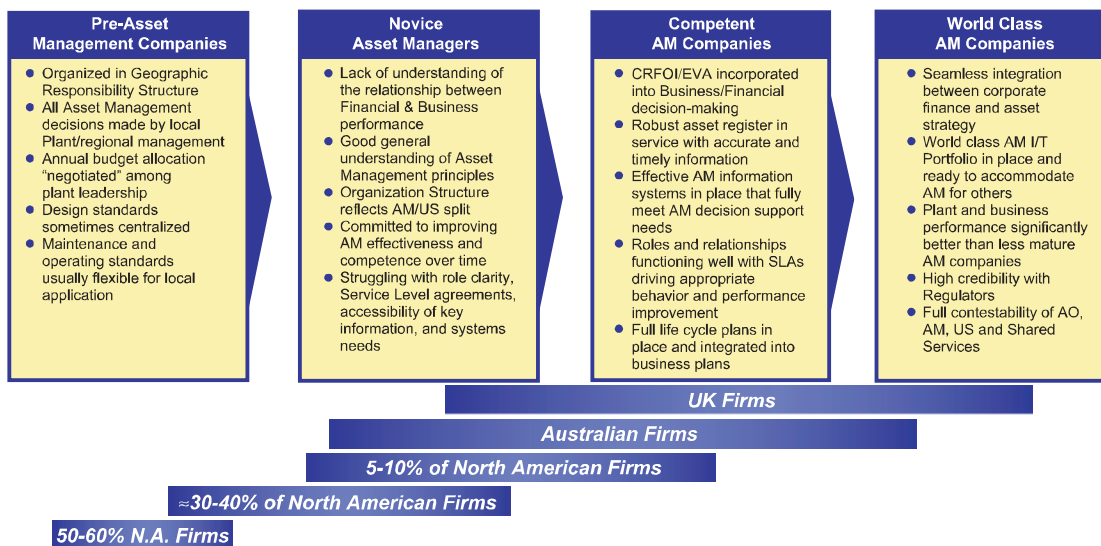


Figure 2: Asset management continuum

market because it introduces new competitors and areas for growth. It is completely consistent with and complementary to other regulatory trends such as performance-based rate making (PBR) and the introduction of competitive energy supply. The key issue for U.S. electric utilities isn't when will it occur but how will we embrace and profit from it?

### The Earnings Growth Opportunity

In its more mature evolutionary phase, which the U.S. market is just now entering, strategic asset management provides a compelling earnings growth opportunity for ambitious utilities. Instead of being limited to the natural growth rate of the existing customer base or being forced to rely on costly and risky mergers, most of which have failed to be consummated, adopting the strategic asset management model provides a clear break-out strategy to asset owners achieving superior earnings performance.

Many electric and gas utilities, particularly those with less than two million customers and the least operationally efficient ones, will observe that within a strategic asset management framework, their most attractive strategic option is to adopt a full asset owner strategy. As such, they will cleanly segregate asset ownership elements of their business (finance, regulatory management, etc.) to separate shareholder interests from the asset management (asset investment planning, contracting) and utility services (operations, maintenance, construction,) elements of their business.

The initial earnings growth opportunity of these focused asset owners lies first in the significant cost

savings and performance improvement they can realize by outsourcing many or all of their asset management and utility service activities. In many cases, their total operating costs (capital plus O&M costs) can be reduced by 10-30 percent in 1-3 years by outsourcing their underperforming business processes to top-performing asset management service providers.

These significant savings come not only from new efficiencies in operation, but from risk-disciplined investment decisions focused on targeted performance. The corresponding increased earnings growth rate provides the basis for a material share price appreciation.

For more ambitious asset owners, the cost savings associated with these transformation activities can provide a compelling rationale behind an acquire-transform-value release strategy for growth/acquisitions.

This process will certainly accelerate with any change in the Public Utilities Holding Company Act (PUHCA). The anticipated repeal of PUHCA has already created numerous non-traditional asset owners (Berkshire/MidAmerican, Dynegy/Illinova, AES/IPALCO, Laurel Hill/TNP) who are well positioned to act on or facilitate this new type of competitor. Many of these non-traditional asset owners have already expressed plans to acquire new properties or transform their current financial structure pending repeal of PUHCA.

With the repeal of PUHCA, it's also easy to anticipate the rise of a new type of utility asset owner – possibly insurance companies, pension funds and other financial buyers – whose focus will be on the attractive quality earnings of the energy delivery business and who will be

disinclined to manage the unfamiliar day-to-day asset management and utility services elements of their business.

Thus, adopting the strategic asset management framework becomes an essential first step for utility management teams who are seeking to attract enthusiastic acquirers as a plan to maximize (and monetize) their share value.

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At TXU, we've found that the combination of our scale, skills and global experiences in the US, UK/Europe, and Australia have enabled us to achieve world-class performance in asset management business processes, information systems and management capabilities. Apart from our core business, we now offer outsourced asset management services to asset owners as a way for these owners to rapidly realize the cost savings and service improvement advantages of our scale and experience. The result for us has been to create an earnings growth opportunity closely tied to our core business, based on our proven competencies, and with a rapidly growing market of new asset owners.

A third earnings growth strategy implicit in the strategic asset management framework lies within the utility services realm. A few T&D businesses have achieved a superior level of efficiency that enables them to provide design, construction and maintenance services at performance levels that far exceeds that of the average energy delivery system. The market for these services is growing rapidly around the world, especially as new industry structures introduce competition in utility services as a way to reduce cost and improve service levels.

#### **Strategic Asset Management as a Catalyst**

Given the market experiences in the UK and Australia/New Zealand and the likely repeal of PUHCA, the horizontal unbundling of the utility industry seems inevitable. Adopting the strategic asset management framework can serve as the catalyst to highlight the shareholder's interest and expedite this transformation process. By breaking down the elements of the currently

integrated energy delivery system – the asset owner, asset management and utility services elements – a forward-looking utility not only can improve operating earnings and corresponding shareholder value, but can begin to identify new value-creating opportunities.

For all but the largest and most efficient energy delivery systems, adopting a strategic asset management framework will lead them to conclude that their best strategic alternative is to adopt an asset owner mindset and structure. The long-predicted consolidation of the industry may not take place via mergers; alternatively, it may be achieved by transforming and consolidating energy delivery systems into new financial and operational structures based on the strategic asset management model. ■

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**Mr. Seibert has an M.B.A. from the University of Chicago and a B.S. in Industrial & Systems Engineering from Ohio State University. He is also a C.P.A.**

**Wade Freeman is executive vice president of TXU and leads TXU Utility Solutions. TXU serves approximately 2.6 million electric customers and 1.4 million gas customers in Texas and 11 million customers worldwide. Mr. Freeman has recently accepted an assignment responsible for asset management for gas and electric, preparing the company for future changes in the wires and pipes business.**

**A native Texan, Mr. Freeman holds degrees from the University of Texas at Arlington and Midwestern State University. He presently serves chairman of the Committee on Power Delivery of the Association of Edison Illuminating Companies (AEIC). He has been with the TXU system for 40 years. During this time, he has held various management positions in transmission and distribution organizations. He has extensive experience in utility re-engineering, mergers and acquisitions in the U.S. and Australia.**