Divide and prosper: unbundling

Management feature

"The value chain is now beginning to break apart, turning generation, trading, transport, distribution, and supply all into separate and discreet businesses with their own particular internal dynamics."

Patrick Demoucelle
Partner
Bain & Company

"For distributors and suppliers, unbundling makes economic sense, allows for better focus, and, hopefully, improved operating efficiencies. The end-consumers should benefit from intensified competition, promising better prices and higher levels of service."

Jean-Charles van den Branden
Manager
Bain & Company

In France's energy market, EDF and Poweo have little in common at first blush. One is the country's largest power utility and serves 40 million companies and households. The other just signed on its ten-thousandth customer in October.

Yet, these opposites both find themselves navigating a critical turn in their industry—the unbundling of supply and distribution.

They're not alone. As a result of the liberalisation and deregulation of European energy markets, most companies in the industry will soon have to understand and carefully manage this market disruption. What has been happening in Belgium portends the shape of things to come. Here, distribution networks have evolved into stand-alone businesses (regulated local monopolies), which are owned entirely or in part by the public sector (municipalities). The Belgian retail supply market has become a competitive battlefield where a dozen suppliers, including Electrabel Customer Solutions (ECS), Luminus, and Nuon, now fight to acquire and retain customers.

> "Belgium can be considered a frontrunning example of how energy industries will evolve."

As always, deregulation requires companies to rethink their game plans. By holding distribution and supply together for too long, or by concentrating on one of the businesses in an undisciplined way, companies can create more problems than they solve. Instead, energy firms need to take a hard look at which business they want to compete in, and then build distinctive customer or cost management skills, depending on their choice.

Supply and distribution are two separate businesses with very different needs for managing costs. Supply costs are based on billing and customer service, while in distribution, which continues to operate as a natural monopoly, the main costs are network depreciation and maintenance. For a company like EDF, which continues to participate in all steps of the value chain, there is very limited cost synergy today between the two businesses.

Since it owns physical assets—the infrastructure network—a separate distribution business will initially hold more value. In Belgium, for instance, distribution represents 70 percent or more of the combined value of a utility. Energy retailers in Belgium and Holland post low margins in supply, typically around -2 percent on corporations to 4 percent on residential and 7 percent on small and medium-sized enterprises (SMEs).

If recent experience in other industries serves as a guide, customers will not easily switch from one provider to another in the early stages of deregulation, so suppliers will need to focus on building a stable customer base at relatively low acquisition cost to achieve returns worthy of their capital employed.

To pull this off, suppliers will need a complex mix of skills ranging from best-in-class power trading and management at one end to best-in-class customer management at the other. Energy is far and away a supplier's highest cost, accounting for about 80 percent of total costs. As a result, suppliers need exceptional purchasing skills and should evaluate the strategic benefits of integrating backward into power generation.

Top players in the supply business also will need to drill deep for customer insights, managing their customer base with precise segmentation around usage, payment behaviour and loyalty of customer segments. For example, in the Belgian residential market, the segment called "married with children" consumes 30 percent more electricity each year than the group labeled "married without children." Understanding this consumption pattern allows an electricity provider to develop an efficient and more focused customer strategy.

By comparison, winning in the newly unbundled, yet still regulated, distribution business will require operators to develop capabilities that unlock value through lobbying their regulator, controlling costs, and both building some scale in operations and some scope in products.

For instance, European regulators have been reducing the revenues they have allowed distribution system operators (DSOs) to collect by an average of 4 percent per year. The only way DSOs can successfully fight the downward

Europe's energy supply

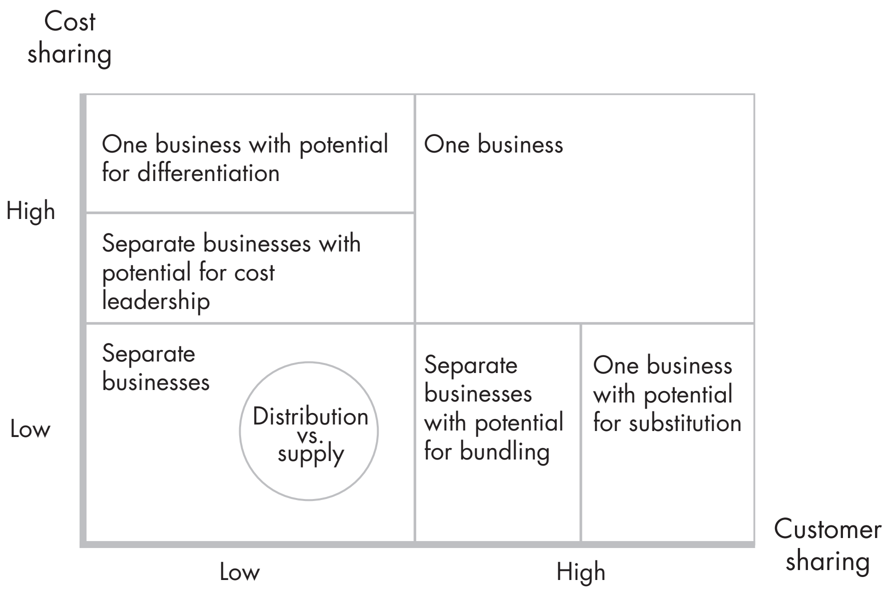

Figure 1:

There is no business rationale for bundling, since cost and customer sharing are limited.

pressure on revenues is to reduce their operating costs at an even faster rate. To outpace regulators, DSOs can focus on redesigning processes according to the best practices in the marketplace. Historically, such benchmarking has proven effective for companies seeking to reduce operating costs in processes such as fault prevention and new connections.

To thrive in this unsettled industry, distribution and supply companies will need to continually refine their focus. Distribution, for example, can be sliced into three separate subbusinesses: asset owners, asset managers and service providers, each of which can be run by separate management focused on different capabilities. In Belgium, asset managers such as Electrabel Netmanagement, combined asset owners and managers such as Sibelga, and full-fledged owners and providers such as Interelectra exist in different regions of the country. At this point, none has emerged as most profitable and efficient.

But the eventual winners will excel at concentrating on the right kind of capabilities. In capital-intense asset ownership, high performers will clearly maximise debt leverage. In asset management, the rewards will go to companies that run the network and manage infrastructure most efficiently, especially through outsourcing. Last, top service providers will cut costs and offer the cheapest service in activities like maintenance or meter-reading.

In supply, companies should focus on designing a business model to consolidate processes and to capitalise on adjacencies that already exist in the minds of customers. Gas and electricity can combine profitably into one business in order to share costs in billing systems and customer management. Moreover, since customers often perceive these two businesses as one, companies can tap the potential for cross-selling, especially when one-stop shopping for gas and electricity is linked to price discounts.

Since much of the expertise needed to succeed in the supply business is in market segmentation and understanding of the customer, credit and billing, and call-center operations, companies may do well to study and adapt models from outside the energy industry that fit this "skill profile." Tomorrow's energy retail supplier may soon need to look and behave more like a bank or credit card company.

As long as suppliers keep the lights on, customers should be able to see—and appreciate—the difference.

"Winning in the distribution business requires operators to develop capabilities in lobbying, controlling costs, and building scale in operations."

In this holiday season, we at Bain & Company would like to extend our warmest greetings to our network of partners, friends, clients and their families. We wish you all a healthy and fruitful 2005, and sustained growth for many years to come.