WHAT'S YOUR SHARE OF THE $5 BILLION PRIZE?

THE CONTINUING CHALLENGE TO KEEP UTILITY CUSTOMERS, REGULATORS, AND SHAREHOLDERS HAPPY

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One of Oliver Wyman's utility clients often states that happy customers lead to happy regulators, which lead to happy shareholders. There is a great deal of evidence to support his statement. Based on our analysis, there are $5 billion of incremental earnings in play across North America. We believe the task of tapping this earnings pool will become increasingly difficult and complex as utilities face the issue of rising infrastructure costs during an economic downturn, as addressed in our recent article "the Wrath of the Customer."[1] Utilities that are not customer focused may face a much more engaged and involved customer, impacting regulators, and placing future earnings growth at risk. It is a potential flashpoint where utilities will have to focus on enhancing the customer experience and building their brand by simplifying and improving their interactions with consumers. Utilities will need to develop new integrated, customer-centric approaches to their strategic, market, regulatory, and financial planning.

1 This article expands upon the themes laid out in "Are You Ready for the Wrath of the Customer" by Michael Britt and Gerry Yurkevicz, which analyzed the impact of increasing retail electric prices.

A BETTER UTILITY CUSTOMER EXPERIENCE AND BRAND RESULTS IN BETTER EARNINGS

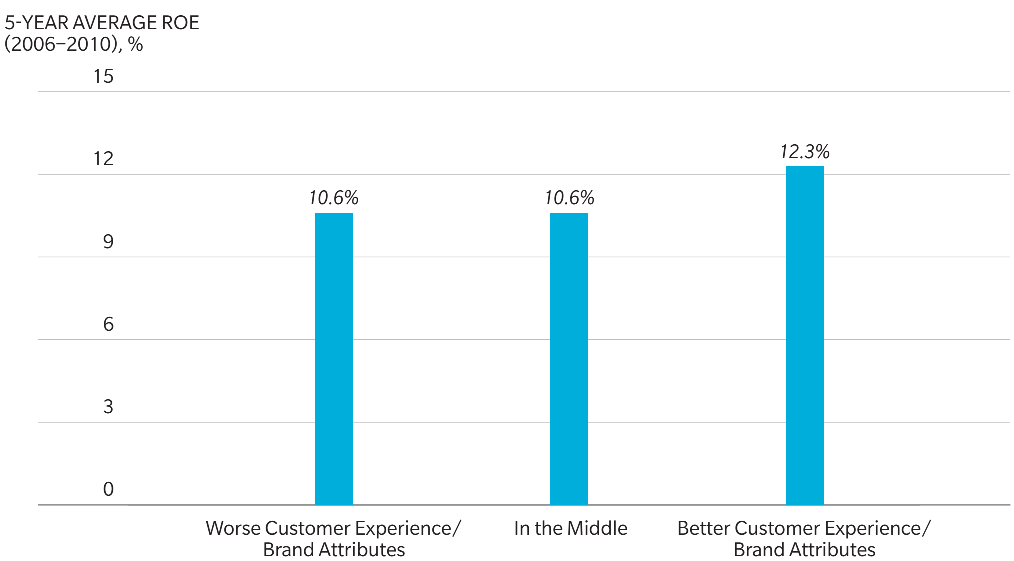
The link between the customer and utility financial performance is real and significant. Electric and natural gas utilities that are better at providing a superior customer experience and building a stronger brand deliver long-term ROEs about 1.7% above the rest of the pack (Exhibit 1). If all investor-owned utilities were equally effective in focusing on the customer and building their brands, their collective annual earnings would be $5 billion higher. Oliver Wyman conducted a comprehensive analysis of customer experience, branding, customer satisfaction, and reputation among North American utilities. We found that:

- Electric and natural gas utilities that are outperforming their peers at positioning, branding, and satisfying the customer achieved average ROEs of 12.3% from 2006 to 2010.
- Top-performing utilities earned ROEs 1.7 points higher (16%) than utilities "in the middle."[2] These "incremental returns" do not occur all at once. They typically reflect years of strong customer focus, brand management, and regulatory initiatives to deliver superior results.
- The worst-performing utilities do not suffer significant penalties: both utilities "in the middle" and "worse" on the customer scale earned a five-year ROE of about 10.6%. Allowed returns embedded in rates provide a floor on earnings levels, somewhat insulating companies from the impact of inferior customer focus.

The results are compelling: in the utility business it pays to focus on building a strong customer brand by providing a superior customer experience.

In the end, happy customers are worth a lot—1.7 points in higher earned ROE

EXHIBIT 1: IMPACT OF THE CUSTOMER ON EARNED ROE



Source: Value Line, PUC filings, Oliver Wyman analysis.

2 These results are similar to our previous analysis covering the 2004 to 2008 period, where the ROE gap between top customer performers and the middle was 1.9 percentage points.

As shown below, there are multiple pathways where a better customer experience and utility brand can lead to superior financial performance (Exhibit 2). Satisfied customers both directly and indirectly benefit shareholders:

- **Direct shareholder benefits:** More satisfied customers contribute to higher demand with greater energy consumption, expansion of business operations, or participation in utility programs and services. Satisfaction also leads to advantageous end-use appliance and equipment decision-making and to better partnerships with trade allies and vendors.
- **Indirect shareholder benefits:** More satisfied customers lead to greater customer acceptance of utility service issues. This is especially important since electric and gas service is generally considered to be a "lower involvement" category of spending by the customer, as it represents a small but growing percentage of household income. Most consumers do not spend more than a few minutes—if any time at all—contemplating their utility service. This low level of involvement translates to lower levels of involvement and impact on the regulatory process.

Satisfied consumers typically help satisfy regulators and politicians. As a result, utilities are often able to obtain more "constructive" regulatory treatment. Often, these include mechanisms and frameworks which enhance utility returns and/or lower risks of under recovery (e.g., capital and expense trackers, generous earnings sharing arrangements).

EXHIBIT 2: THE CUSTOMER, REGULATOR, AND SHAREHOLDER CHAIN

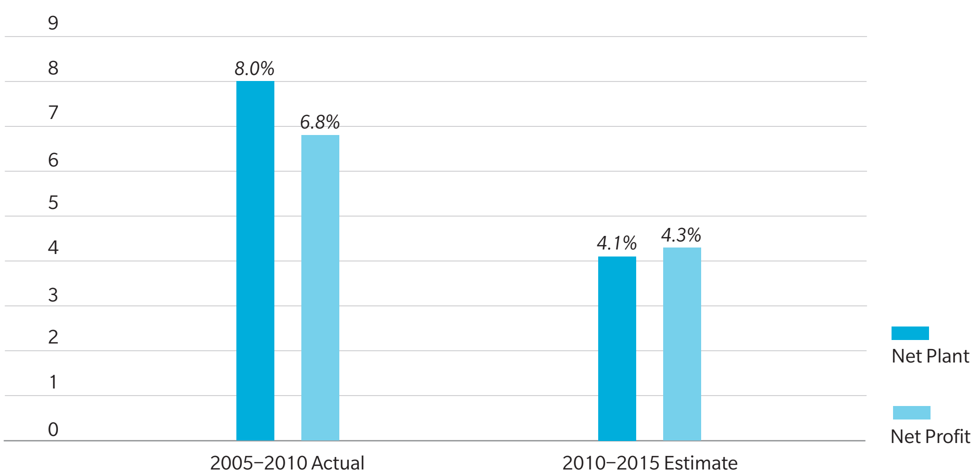
HAPPY CUSTOMERS LEAD TO . . .	HAPPY REGULATORS LEAD TO . . .	LEADING TO . . .
DIRECT IMPACTS • Higher consumption (e.g., kWh, therms) or participation rates in efficiency programs • Higher share from new & replacement equipment decision-making • Better relationships with allies & suppliers driving improvement in specification of equipment INDIRECT IMPACTS • Fewer customer complaints • More customer acceptance of business as usual, in the low involvement utility spending category • Less customer intervention in regulatory or political processes	• Better regulatory frameworks allowed by regulators • Progressive test year • Trackers for key capital or O&M categories • Advantageous de-coupling or normalization provisions • Better regulatory and tariff terms & conditions • More earnings opportunities by utility • Fewer allowed ROE issues • Incentive or sharing mechanisms • Looser multi-state utility or non-regulated standards • Better results with legislative initiatives	HAPPY SHAREHOLDERS SUPERIOR EARNED ROE AND HIGHER STOCK VALUATION

UTILITIES NEED CUSTOMER AND REGULATORY SUPPORT IN THEIR QUEST TO GROW FUTURE EARNINGS

Utilities need the help of their customers and regulators to support spending plans, rate base growth, and earnings growth to meet regulatory obligations and shareholder expectations. Over the period from 2005 to 2010, the "back-to-basics" strategy of most utilities led to annual capital spending on net plant (a good proxy for rate base growth) of about 8% and earnings growth of 6% to 7%. This earnings driver is expected to continue. Over the period from 2010 to 2015, electric and natural gas spending on net plant is expected to average over 4% annually, driving an equal increase in annual earnings. Utilities that are more successful with the customer and regulator will see higher levels of allowed spending and earnings growth to maintain or improve aging infrastructure or meet environmental requirements.

EXHIBIT 3: UTILITY INDUSTRY SPENDING AND EARNINGS GROWTH

CAGR PERCENT PER YEAR



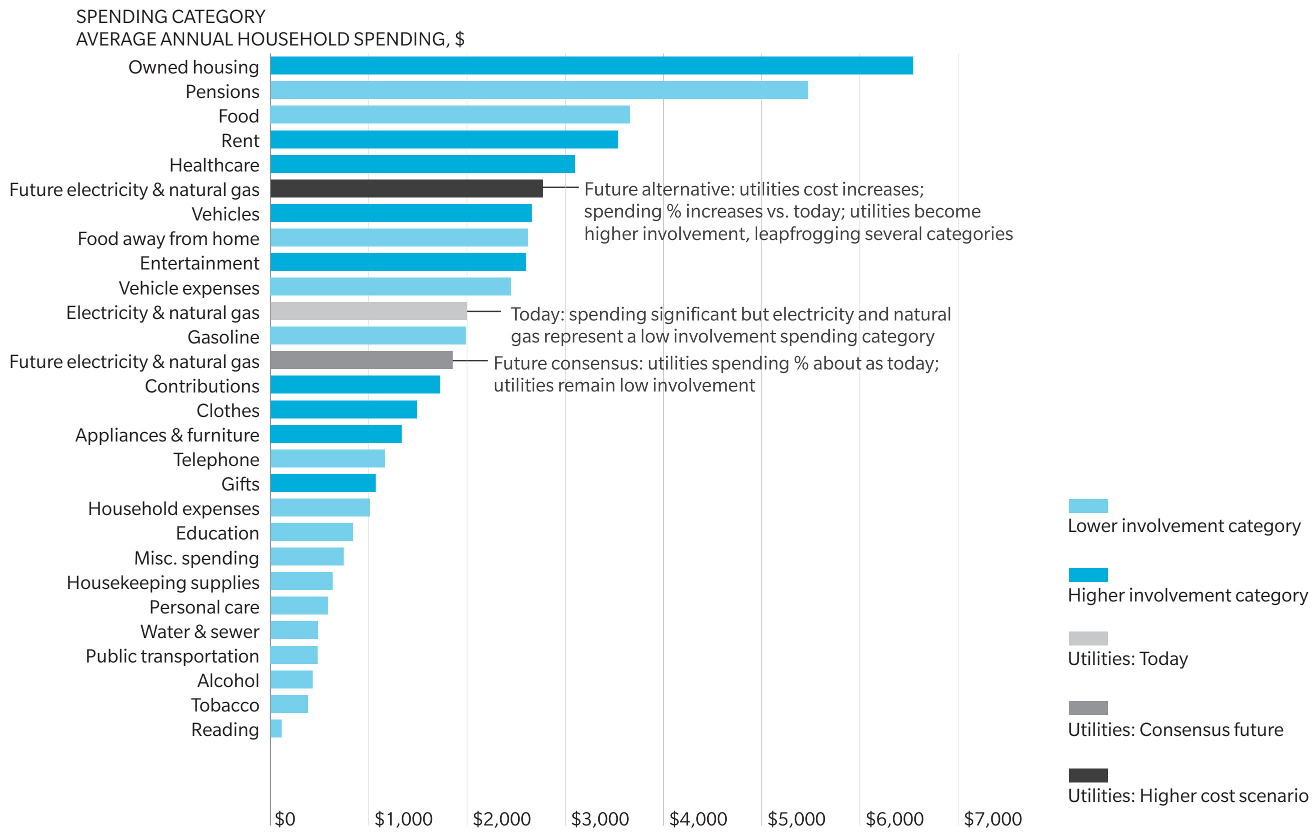
Source: Value Line, Oliver Wyman analysis.

GET READY FOR MORE CUSTOMER INVOLVEMENT, PLACING EARNINGS AT RISK

Unfortunately, there is a plausible scenario where this beneficial customer-regulator-shareholder relationship breaks down. Examining where spending on electric and natural gas fits in with overall consumer spending sheds light on what a difficult time utilities are likely to face in the future.

Based on our analysis of U.S. households, the electricity and natural gas category sits about in the middle of the spending spectrum—at about $2,000 a year. Utility spending represents a low involvement category—consumers typically do not want to devote much time, thought, energy, or resources to the purchase process. Utility spending is similar to other low involvement categories such as gasoline, restaurants, and food. Spending tends to be greater for higher involvement categories such as owned housing, healthcare, and vehicle purchases (Exhibit 4). Though utility spending is generally lower involvement, it is not an insignificant amount—averaging 4.1% of household income (Exhibit 5).

EXHIBIT 4: HOUSEHOLD SPENDING—UTILITY COST AND IMPORTANCE

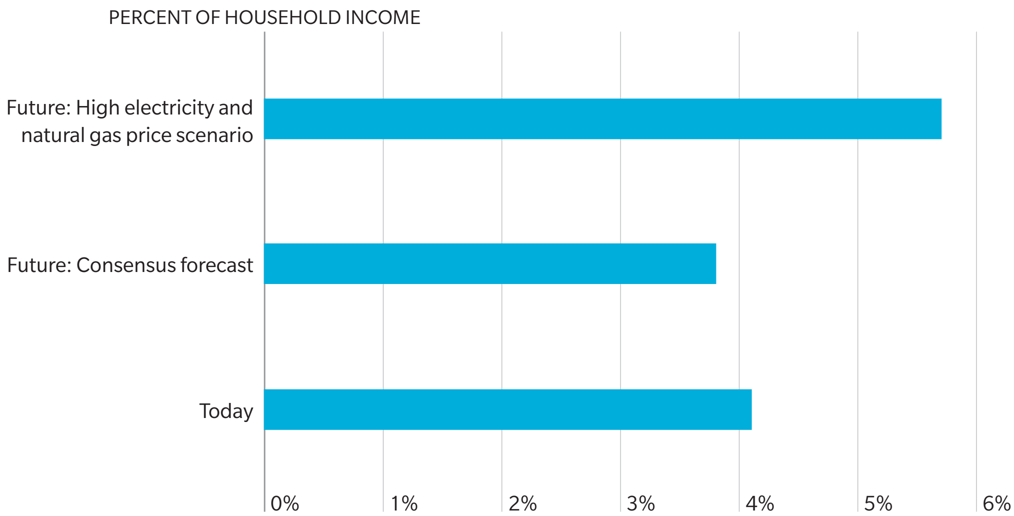


Source: U.S. Bureau of Labor Statistics, *Consumer Expenditure Survey*; U.S. EIA, *Annual Energy Outlook 2011*; Oliver Wyman analysis.

What does the "business as usual" view of the future look like? The consensus view is for utility services spend to remain fairly flat over the next five years. The consensus view suggests that the cost of capital investment for new renewable as well as non-renewable generation and T&D infrastructure will be offset by price decreases from abundant natural gas supplies (e.g., driven by more hydrofracking for shale natural gas), energy efficiency, and cost-reducing technological change.

Unfortunately, there are multiple factors that could change this expectation of flat spending. Any combination of pending regulatory rules from the Environmental Protection Agency (EPA), reduced recovery per shale gas region or production well, financing difficulties with shale production, lower consumer acceptance of energy efficiency measures, or higher costs of rebuilding the aging electric and gas infrastructure could well reverse the situation. This scenario could drive relative consumer spending on utilities to almost 6% or more of household income. If this were to happen, utility spending could leapfrog other categories, such as entertainment and vehicle purchases, and begin to approach healthcare in significance. At this higher level, spending on utilities might evolve from a lower to a higher level of involvement in the eyes of the consumer. Future utility earnings could be put at risk by the increased scrutiny and involvement of consumers, particularly if it leads to political pressure on regulators to keep rates low.

EXHIBIT 5: HOUSEHOLD SPENDING ON ELECTRICITY AND NATURAL GAS UTILITY SERVICES



Source: U.S. Bureau of Labor Statistics, *Consumer Expenditure Survey*; U.S. EIA, *Annual Energy Outlook 2011*; Oliver Wyman analysis.

UTILITIES MUST IMPROVE THEIR CUSTOMER EXPERIENCE AND BRANDING

Given the customer's importance as a potential driver of future earnings, utilities should consider them in a new light. We recommend that utilities develop the following:

- **Holistic consumer view:** The consumer interactions with the utility must be considered and managed holistically across multiple dimensions, including payment centers, contact centers, website, social media (e.g., Twitter, Facebook) and automated interaction through programmed devices.
- **Customer segmentation:** Insights from effective customer segmentation represent the key to more effectively building customer relations, despite the scale issues of developing meaningful customer connections in the lower involvement mass market.
- **Consumer demand engineering:** Utilities should embark on a new wave of customer

research and analysis, including demand engineering, using tools such as "hassle maps" to design products and services that are "solution focused."

- **Regulatory strategy:** It is prudent to invest in better understanding state and federal regulators and to critically evaluate utility regulatory strategy. Consider using hassle maps for regulators and staff to more effectively communicate key messages and to advance policy objectives.
- **Customer-focused planning:** Utilities should move beyond "bill impact" and explicitly consider customer issues in all strategic, market, and financial planning.

Each of these recommendations is discussed below.

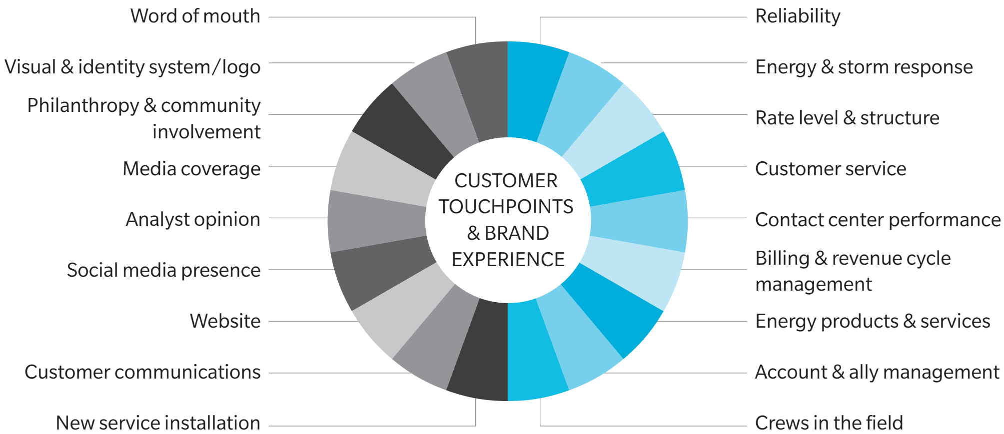
THE VALUE OF A HOLISTIC VIEW OF THE CUSTOMER

In this market, it is important to understand and invest in those customer touchpoints that are critical to enhancing the customer experience and building the utility brand. The 80-20 rule very much applies, since not all touchpoints equally influence customer behavior. Utilities need to establish a realistic and accountable process for managing key customer touchpoints, investing smartly, and measuring results.

We have noticed that many utilities are beginning to embrace a more customer-centric model, with the creation of Chief Customer Officers or VPs of "the Customer Experience" on organization charts. Frequently, however, these efforts are too narrowly focused to have the intended impact. For example, creating a few new positions and then focusing only on contact center touchpoints (e.g., introduction of a new CRM/CIS system) while ignoring other critical aspects (e.g., CAIDI-related reliability issues) will create some value, but misses the significant opportunity created by a more holistic view. To position the utility to capture these benefits, customer touchpoints need to be considered and addressed in an integrated fashion.

Utilities often launch cost reduction efforts, consolidation, or standardization under the guise of customer improvement. This is because the traditional view has been that customer service and interaction are cost centers that must be managed and reduced rather than cultivated as an opportunity. We advocate a balanced approach—where management focuses on the types of interactions that truly matter to improve the customer experience and brand—while learning from each customer contact.

EXHIBIT 6: UTILITY CUSTOMER TOUCHPOINTS AND BRAND EXPERIENCE



A holistic view of touchpoints allows a more tailored solution for customers. This can increase customer satisfaction and reduce costs, because solutions are achieved efficiently, with better customer information available to the customer and the utility professional at key touchpoints.

CUSTOMER SEGMENTATION

As is the case for most customer-focused programs, drawing insights and tailoring solutions based on the needs and characteristics of customer segments is crucial to designing a robust customer experience and to building the utility brand. Utilities need to collect, maintain, and efficiently analyze the avalanche of customer data from all of the individual customer touchpoints identified in Exhibit 6. To lay the foundation, it is often necessary to create a Customer Experience and Branding Analytical Engine to enhance data collection and management in support of the utility's customer segmentation efforts.

CONSUMER DEMAND ENGINEERING

Utilities can learn from a number of other industries that have created compelling customer-focused products and services before the customer understood what they really wanted, using "demand engineering." Oliver Wyman's recent research into the leaders that have created today's most successful products and services show that they all share an ability to experience the world through the eyes and emotions of customers.[3] These companies catalog every frustration, time-wasting complication, and source of uncertainty. Successful companies watch their customers use their products to get the most value—because people do not always have the ability to express their specific energy-related needs beyond low cost, reliable, and clean. Finding commonalities across segments to connect the dots driving consumer behavior leads demand creators to bridge the huge gap between what people settle for and what they really

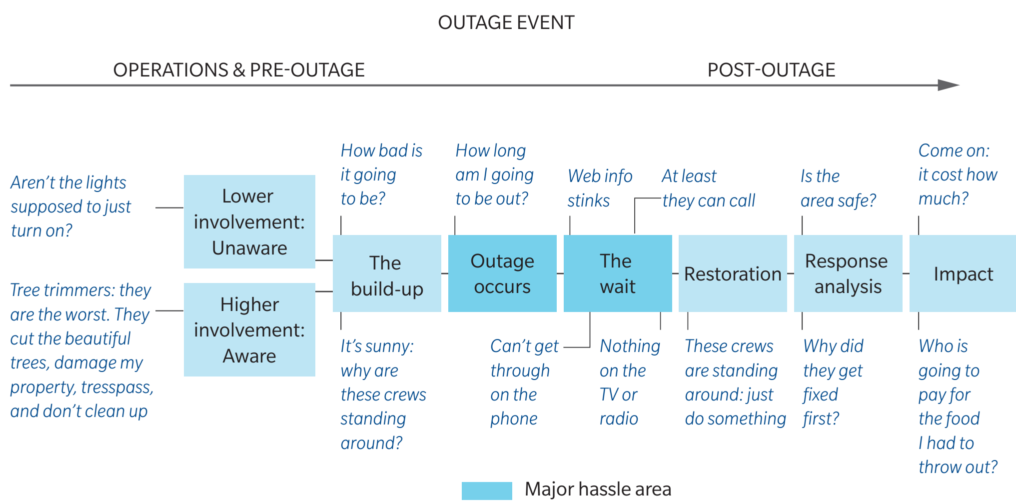
3 Demand: Creating What People Love Before They Know They Want It, by Adrian Slywotzky, Crown Business, October 2011, details our most recent consumer research. http://www.demandthebook.com/

want, spawning such demand "stars" as Apple, Zipcar, Nokia, Netflix, Nespresso, Amazon, and CareMore.

Utilities can learn from these leading innovative companies—Exhibit 7 provides an illustrative "hassle map," a tool used to better understand the customer experience. Unfortunately, most utilities fail to focus on the key question consumers ask: "What do I hate about my electricity and natural gas utility service?" It is not surprising, since most utilities provide just average service.

Mapping customers' hassles with utility service should be a top priority. Customer hassle maps should help set the utility agenda to design products and enhance service delivery across customer touchpoints. Working ruthlessly to eliminate or minimize major service hassles drives the business priorities of successful innovators and creates the environment for significant future value creation.

EXHIBIT 7: HASSLES OF A MAJOR EMERGENCY OR STORM OUTAGE AND RESPONSE



ENHANCED REGULATORY STRATEGY

Regulators represent the utility's most important key account, and the utility should seek to continuously enhance its understanding of the evolving needs and objectives of its regulators. As hard as it may seem to be in some jurisdictions, we suggest that utilities consider developing "regulatory hassle maps," like the illustrative version provided in Exhibit 8, for their regulators and key government entities. A utility should ask "what do regulators hate" about how the utility carries out its business and delivers service. A utility should catalog frustrations, time-wasting complications, and sources of uncertainty or irritation to regulators. It should also segment regulatory areas—thinking about "hassle maps" differently for commissioners, PUC staff, consumer advocates, and other key influencers of the regulatory process. Where possible, it should seek to eliminate the impediments to improved regulatory relations and enhance the potential for collaboration on constructive regulatory outcomes.

EXHIBIT 8: HASSLES OF THE REGULATORY PROCESS

CUSTOMER-FOCUSED PLANNING

Our research suggests that the customer should play a larger role in utility planning and decision-making. A customer-centric strategy that is comprehensive will extend from the company's operational, financial, and regulatory processes through to its strategic planning. Too often, we see utilities merely asking what the "customer bill impact" is going to be of a certain strategic option. We believe utilities should be integrating the customer more directly into all aspects of the planning effort, asking such questions as:

- What customer initiatives should we be undertaking that mitigate the major "hassles" of our key customer segments?
- What incremental returns should we expect if we implement these customer-focused initiatives?
- How much are we leaving on the table or losing by not focusing on enhancing the customer experience and utility brand attributes?
- What are the tradeoffs between customer experience-building and cost reduction initiatives in meeting our targets?
- What are the market, regulatory, and financial implications of higher levels of customer involvement in utility purchasing decisions?
- What planning assumptions and results should we challenge if we use a more customer-centric lens?

Answering these questions will go a long way in determining whether a utility will share in the $5 billion in additional earnings available to those utilities that successfully focus on the customer.

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Oliver Wyman's Energy team helps utilities and related energy companies address strategic and operational challenges through proven, results-oriented approaches. We have completed hundreds of engagements for more than 75 leading electric, gas, and water utilities across North America, Europe, and the Middle East creating sustainable shareholder value.

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