CHANGING THE BUSINESS FOCUS OF UTILITIES

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Summary:

The pace of restructuring and liberalisation in electricity industry is speeding up. As this process quickens, clients are changing their attitudes and at the same time they become more active in their choices and demand harder from their suppliers, whilst taking advantage of new market alternatives.

The key to any distribution utility strategy is to meet customer needs profitably. In order to do that, companies should aim to reach excellence in its core business - maintain existing customers and expand its customer base, strengthen its credibility as a supplier, enhance revenues and control costs.

Therefore, values and models of management have to change and companies have to bear in mind that in an integrated energy market companies provide energy services to its clients. The distributor should add value to the services it is providing its clients with and be ready to have a broader role which fits the needs of its clients.

The critical issue is to find the answer to the following questions: What do clients want and how to meet it efficiently and profitably?

1. THE ISSUE

Energy markets are becoming increasingly liberalised and regulation is changing both in scope (electricity utilities are more complex) and objectives (government intervention is smaller).

Reasons underlying such changes are, naturally, arguable, but its basic features are identifiable. On the one hand, globalization of economies has created new competitive pressures for industrial companies in developed countries, (a number of companies from developing countries is entering the market, with low labour costs and low capital expenditure) and decreased some of its competitive advantages (lower cost of capital, easier financial flows, etc.). Under this new situation, those companies have an imperative need of gaining different competitive advantages and to make cost reductions in new areas. Cost of utility services and infrastructures is a new area for cost reduction, taking advantage of the better infrastructures that developed economies have. The consequence is that the cost of utility infrastructures is under more severe scrutiny.

On the other hand, developed economies are based on customer choice and, apparently, it makes no sense to have utility customers without a choice. And of course, in Europe, there was a need to make effective the internal market and the economic community in industries, such as utility infrastructures, where the logic of a country market, as opposed to the logic of a community market, was still dominant.

This paper tries to answer questions arising from such restructuring and liberalisation, in particular, if management paradigms will change, and if so, into what direction and how can current management anticipate those changes.

2. KEY CONSEQUENCES OF THE REFORM

Historically, the electricity industry had no need to differentiate its products and services or communicate with its customers. It offered an homogeneous product in a protected service area. Marketing was simply a matter of extending power lines and connecting new customers. There was little incentive to learn about the customers. Either they wanted electricity or they did not.

The process of reform will radically change this picture and will make the electricity industry work under the same competitive pressures like other businesses do.

This process will both bring new competitors to the electricity market, putting market-share of traditional utilities under pressure and increase the number of options available to clients, making them more aware of their power and more demanding from their supplier.

The electricity industry, long accustomed to providing all customers with a single homogeneous product and undifferentiated service quality has to realise that the electricity business is about to become a competitive marketplace, working under rules and criteria that are common to any other market-driven business. In a common marketplace it is not the customers who have to adapt to the company circumstances and decisions, but the

company which has to adapt to client's preferences and judgement. The utilities have to realise what clients really want and understand that clients are not homogeneous, some simply want to buy electricity while others are searching for the services energy (as a whole) provides for, some prefer a higher level of service (e.g. higher reliability and power quality) and are willing to pay for it, while others prefer for instance a lower level of service at a lower price.

Therefore, utilities have to become "customer-driven". The continuing prosperity and growth of electricity industries will depend on its willingness and ability to embrace a number of new business strategies, focusing on meeting customer needs at prices, on the one hand they are willing to pay and on the other hand, are lower than those offered by its competitors in the marketplace.

The key to answer those challenges is differentiation. The electricity industry has to offer new services and adopt new pricing and market strategies, exactly like other competitive industries do. Those competitive tools are not new, but their implementation by an industry that sells a single homogeneous commodity requires radical changes and new management priorities. Amongst those, utilities will have to:

- increase cost-efficiency;
- differentiate the services the utility provides;
- cater for the needs of customers;
- enlarge its value chain;
- concentrate on activities of that value chain that are more capable to provide value for its shareholders.

This requires action in a number of areas:

- Fostering technical innovation because product differentiation, market segmentation and price targeting require new technologies in electric metering, monitoring, communications and control.

- Designing and implementing new information systems because, to manage the new marketing and pricing schemes, the industry will have to collect, manipulate and process far more information on its customers than it does now.

- Promoting cultural changes**,** because in a competitive environment, utilities have to become a "true" service industry, have to be capable of identifying business opportunities in non-electricity energy services in order to satisfy customer needs, have to be more cost efficient, in order to maintain a competitive edge over its competitors and have to adjust their internal organisations to respond to those challenges.

3. BRINGING THIS NEW THRUST INTO PRACTICE

3.1 - Creating conditions to satisfy customers and maintain a long term relationship with them

In the near future a key factor for the success of EDP distribution companies is to have a better understanding of its customers. The critical issue is to find the answer to the following questions: **What do clients want and how to meet it efficiently and profitably?**

Of course, to design a meaningful strategy under such a situation, one needs to understand that different segments in the electricity market have different choices, different attitudes towards services provided by electricity, different needs, different satisficing criteria and provide its suppliers with different value.

A careful segmentation must, therefore, be in place. A winning strategy for clients having alternative sources of supply (e.g. eligible consumers or those consumers with a potential to shift to CHP) is quite different from a strategy for captive customers. Even if one has to understand that the number of captive consumers tends to diminish over time.

For the majority of customers, electricity costs represent a small part of the total costs of doing business. This is true for residential, commercial and most industrial customers. Many other factors, such as labour costs, product quality, ease of use, ease of maintenance, convenience and comfort are considered in choosing energy appliances and processes or energy efficiency improvements.

The utility must be capable of understanding those differences and have a different approach to each customer segment.

3.2 - Changing the utility attitude

To maintain its current customer base utilities have to integrate value-based planning, maximising both its own revenues and the value customers receive from the services delivered. This could represent a major leap beyond the utilities' traditional service philosophy.

Utilities have to develop procedures in order to collect better information about their customers and the values they attach to different energy services.

This means changing from an electrical oriented utility into an energy oriented company, changing the utility attitude from "selling kWh" to "selling what customers need to satisfy their own necessities and expectations". A

market-oriented utility is also a service oriented company, catering for value for its customers, out of the final usage of electricity, rather than supplying them with an undifferentiated commodity such as electricity. At the same time, the utility diversifies into other business, countering the effects of low growth in electricity.

A market-oriented company has to profitably provide value to its customers. But the value of electricity is derived from those industrial or commercial processes that become possible with the use of electricity and remain out of reach without it.

Most of those processes are closely connected with other processes only possible with the use of other forms of energy. It is, therefore, only rational that a market-oriented electricity company becomes a market-oriented energy company.

To do just that utilities have to pass through several changes, cultural, technical and otherwise, in order to:

- Incorporate other forms of energy in the services they provide (for instance, supplying some of its customer segments with an energy-package that fully addresses its energy needs).
- Enlarge their technological base, to become capable of responding to the broader role it is envisaged.
- Embody other forms of energy into their planning goals and instruments.
- Deepen their knowledge of customers, to understand both how they consume energy and how electricity merges into each customer energy process.

3.3 - Proposing ESM and co-operation in new areas

In a competitive environment, customers will decide what is best for them. Rivalry among competing energy suppliers (e.g. different gas and electricity companies), manufacturers of energy efficient appliances, conservation and load management providers, and a new breed of energy consultants will give customers new powers to choose. Energy brokers will help customers decisions process and ensure the smooth functioning of the market.

Choosing among more complicated pricing systems (e.g. time of use, real-time pricing or commercial interruptible rates), alternative energy suppliers, or alternative energy management and conservation devices will not be easy for most of the customers. And this is a tremendous opportunity for energy consultants and brokers to step in with advice.

Where will these energy consultants come from? Who is in the best position to help the customers? Who has access to the best information? Existing utility companies are obviously well placed to help. They have the best information about the customers, the latest information on state of the art energy efficient appliances and devices, the best know-how to install, operate, and maintain these devices, and access to low-cost capital to make the necessary investments. At the same time the utility will gain a competitive edge over its competitors.

4. CREATING A MARKETING-MIX TO EACH SEGMENT

As we said, a careful segmentation is the basic tool to implement differentiated energy services to customers and to understand what clients want and how to meet it efficiently and profitably.
The process of setting the segmentation must be capable of identifying a large number of “variables” or “indicators” , representing clients preferences and expectations.
Amongst those there are:

- The “identification of the uses” each customer gives to electricity and energy.
- The “prioritisation of those uses” and the “technical restrictions” customers have (for instance, there are large differences between a customer that uses electricity for lighting and a customer that uses electricity as its basic input for an industrial process).
- The “degree of substitution” of each form of energy, quantifying the possible utilisation of other energy’ forms to satisfy the same final uses and, vice-versa, the amount of final uses that are being satisfied by other energy’ forms that could be replaced by electricity.
- The “degree of rivalry” of each segment, evaluating the number of alternative suppliers capable of satisfying the same client and the competitive positioning the company has on each segment.
- The “energy intensity” and the “electricity intensity” of each segment, identifying the size of each customer’s consumption and the ratio of its energy and electricity costs to the overall costs of doing business.
- The “basic values” of each segment, that is what do clients value most: reliability, continuity, quality of supply, commercial attention, ...
- How the “utility is rated” by each segment against those basic values.

- The "attractiveness" of each segment (size, value added to the utility, potential for growth, ...).

- The "energy to competitiveness ratio", identifying the importance of energy supplies to the overall competitiveness of each segment, differentiating those who are more "indifferent" from those who are more "sensitive".

- The "load diagram" of each segment and the "tariff option" chosen by each customer.

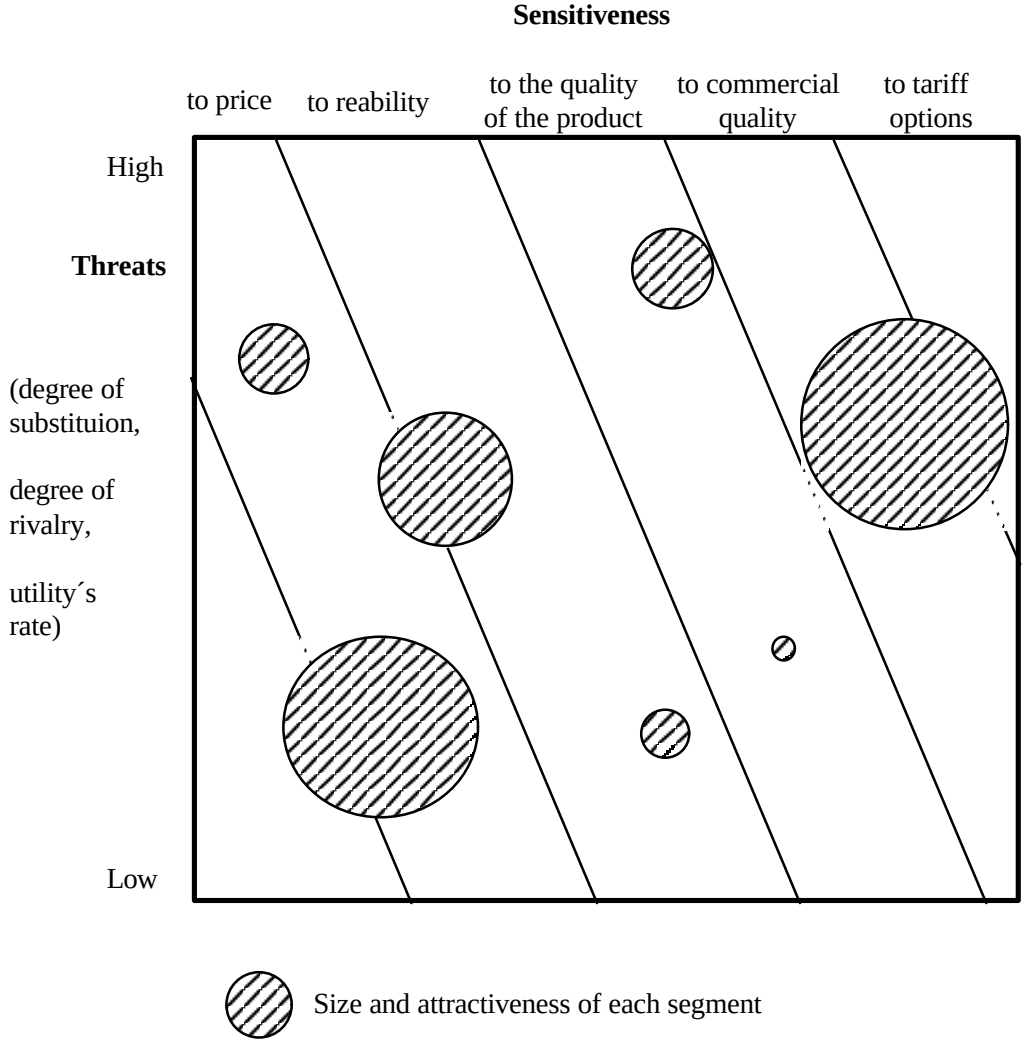
Marketing research is crucial at this stage. A large marketing research campaign has to be launched in order to identify segments. A possible approach could be dividing customers into 3 categories (large, medium and small) and using different research methodologies to each category.

For large customers (for instance clients with a "contracted capacity" equal or above 1 MW) marketing research should be extensive, visiting each customer and filling with them a comprehensive questionnaire aimed at identifying its positioning against those "variables" and "indicators".

For medium customers (clients with a "contracted capacity" above 30 kW and below 1 MW) a pre-segmentation should be made (for instance, distinguishing industrial clients from commercial clients) and each pre-segment should be studied by means of a sample (covering, for instance, 5 to 10 % of all customers in each pre-segment) on the basis of questionnaires addressed to each segment. Customer contact could be indirect (questionnaires sent by mail) or direct (a meeting with customers after the reception of questionnaires).

For small customers the basic features of marketing research could be those used with medium customers (pre-segmentation, samples, no necessary direct contact) except that pre-segments should be different, samples would cover a rather small proportion of customers in each pre-segment and some of the contacts could be much simpler (by telephone, for instance).

The marketing research campaign will enable the definition of segments and the setting of a value-segment matrix highlighting the characteristics of each segment against 3 criteria: "threats", "sensitiveness" and "value-added" by the segment to the utility:



Finally the utility has to design a marketing-mix addressed to each segment. Elements of such marketing-mix could be:

- a “tariff system” and a set of “tariff options” addressing price sensitiveness, the load diagram and the ability of each segment to manage its consumption;
- a comprehensive package of “services beyond the meters” to each segment (the utility would identify a large number of those services) and the marketing-mix for each segment would then result of a combination of some of those;
- a package for “integration of energy services” (counselling, packaging of different energy forms into a single services offer, engineering the energy processes of each segment’s energy use, ...);
- specific measures addressed to segments where the degree of substitution and rivalry is high and where the utility rates low.

The marketing-mix should, finally, be served “ready-to-use” to customers, but flexible enough to adjust, adapt and integrate into each customer needs and expectations.