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Capabilities- driven strategy

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**Redefining utility
leadership for a
new environment**



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Executive summary



The energy debate — over issues from climate change to energy sustainability to new generation to smart grid — will change how people think of energy and of the role of the utility as a provider. Regulators and consumers are spurring demands for new investments; significant choices must be made, many of which ultimately will erode shareholder value. While instinct is leading some industry participants down the same worn-out path to temporary cutbacks, a new crop of “architect CEOs” are recognizing the need to realign their companies’ capabilities and performance models with this emerging market, to both meet these new demands and take advantage of emerging market opportunities. These emerging capabilities-driven models seek to optimize overall performance, not necessarily to minimize costs, by building the operating model around those key capabilities most required for strategic success.

Executives at leading utilities are reassessing their competitive strengths, from generation to distribution to marketing to corporate services, and engaging in necessary trade-offs to focus on value-added capabilities and de-emphasize those that are easily commoditized. At the same time, they are addressing underlying strategic and foundational fissures to help ensure that their performance gains last. Removing organizational snags such as unclear decision rights and weak performance management structures is enabling employees in every facet of the business to move quickly and efficiently to support the CEO’s strategic blueprint.

The utility of the future that emerges from this program of step transformation will be leaner, more performance-oriented, technically diverse, and able to drive changes in the market rather than merely reacting to them.

The performance leadership challenge

The changing market is challenging the way utilities operate, thrusting new capabilities to the forefront and creating a permanent need for fundamental performance improvement. It seems that every facet of the utility business model is under siege. The carbon reduction agenda is ratcheting up pressure on companies to diversify generation portfolios, upgrade transmission networks, and engage consumers in demand-side management programs. New digital technologies offer the prospect of an increasingly intelligent grid and workplace. Customers are becoming more sophisticated than they have ever been. And talent requirements are changing as a massive generational shift occurs in the workforce.

Taking an innovative approach to revising ingrained ways of doing business, and successfully building the capabilities that will be needed to meet these challenges, will require executives to develop a refocused vision of their utility enterprises — one in which new performance models dominate. They will increasingly strive to differentiate their performance from their competitors' by embracing capabilities-driven strategies.

Research and our experience suggest that long-term leaders in all industries inevitably excel in a small number of core capabilities that are aligned with their strategy. This focus on capabilities sets them apart from their peers in terms of shareholder value performance. The establishment of capabilities-driven leadership rests on three fundamental elements that predict leading performance.

- *Strategic clarity and flexibility:* Leaders have clear, concise strategies that are seamlessly translated into action throughout the organization. They possess superior market insight, financial management, and integrated planning capabilities that allow them to respond to market change before their peers do.
- *Differentiated capabilities:* Leaders focus their resources on a small number of key market-oriented capabilities that directly support their strategies and differentiate them competitively. They do not make commitments to noncore or low-value activities.

- *Strong organizational DNA:* Leaders possess responsive governance structures, effective decision-making processes, and cultures that reward performance. They enable performance with strong talent, accountability, and incentive processes.

The presence of these three corporate characteristics strongly indicates sustainable performance leadership. All three are necessary; no single characteristic is sufficient. Embedding these performance characteristics in a company, however, requires more than traditional, incremental changes to the business. It demands no less than a fundamental transformation of the business model. To be effective, such a transformation must be driven by senior management, with rigorous discipline around its design and execution. It will, and should, create discomfort in the organization. It is not easy, and few achieve it. But the rewards are substantial. Operating benefits in the range of 15 to 20 percent of total operation and maintenance (O&M) and capital spending are typical. But, most important, the focus on key capabilities will allow positioning as a sustainable industry leader over time and across market cycles.

Although there exists a natural instinct to manage conservatively during a downturn, today's unique combination of environmental initiatives, new technologies, and economic constraints calls for decisiveness in redefining and improving performance. Aspiring leaders will break from the cycle of budget freezes, layoffs, rate hikes, and other knee-jerk actions typically employed to sustain profit during downturns. Instead, they will create lasting platforms for change. Those utilities that get it right will retain or improve their financial health and grow. Those that get it wrong will face declining operating margins, stranded capacity stemming from CO₂ constraints, and potential acquisition by stronger rivals.

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Market disruption: The transformation of the business model

Ultimately, the utility of the future will be a fundamentally different company — more performance-oriented, more technically diverse, larger in scale, leaner, and more analytically driven. The performance bar will rise materially.

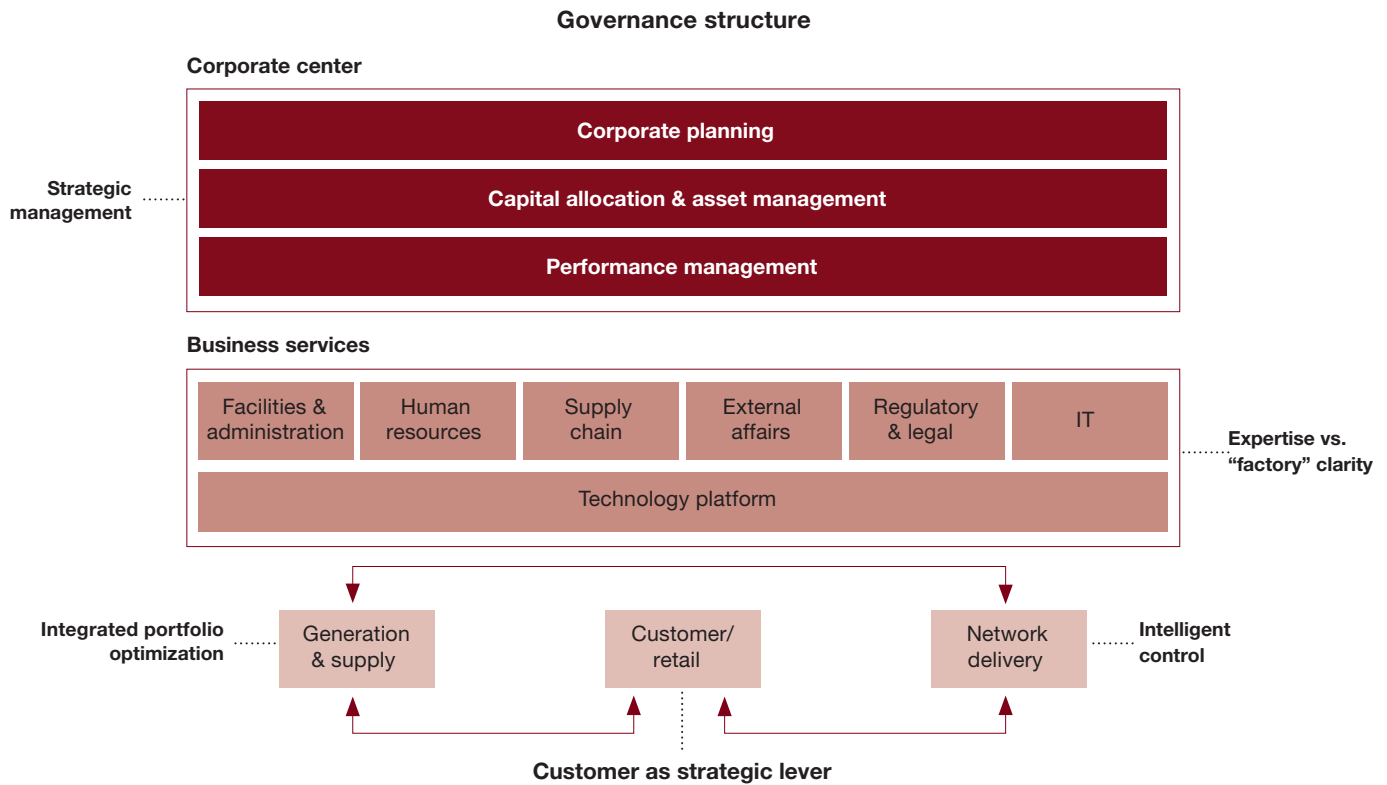
Data, and its application to increasingly intelligent decision making and network control, will form the foundation of redefined performance in the utility industry. The industry will be redefined as we evolve from “dumb” assets and operations to intelligent automation and control. This explosion in information will be accompanied by more sophisticated analytic and decision-making models. Expertise capabilities, including performance and financial analysis, will expand to support predictive and foresight-driven analytics, allowing greater long-term capital/asset efficiency, improved workforce productivity, and increased reliability and responsiveness to service events. Asset management is a key example of an area in which improved performance data will permit more accurate and extended asset lifetime analysis and the eventual transition from preventive to predictive management cultures.

Leading utilities will come to abandon the traditional one-size-fits-all business model in favor of organizations that better align and support their strategies, whether environmental stewardship or nuclear development. The challenge will be defining the right mix of capabilities and bringing about the necessary level of change to effectively support strategic execution. Success will create a more nimble, internally aligned organization that effectively blends 21st-century assets and capabilities with the ability to anticipate and quickly respond to shifting priorities and mandates (*see Exhibit 1, next page*). Each part of the business will be redefined:

- *The corporate center and corporate services:* Corporate functions will increasingly shift into the role of strategic partner as utilities evolve from a largely operating-oriented management model to a model characterized by broader strategic management and analytic capabilities.

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Exhibit 1
The redefined utility business model



Source: Strategy&

- *Generation and supply*: Despite starts and stops, generation will continue its evolution to a “smart” market-oriented focus, demanding an increasing focus on a fundamentals-based portfolio strategy, project development skills, and into-the-market commercial capabilities.
- *Network delivery*: Smart technologies will usher in the era of digital intelligence, creating opportunities to dramatically improve productivity and the way in which utilities relate to customers in real time.
- *Customer and retail*: The customer organization will increasingly become a strategic lever for the company, integrating with supply planning and bringing to bear greater expertise in core marketing, channel management, and customer service.

Where do you stand?

Utilities executives must ask themselves a few key questions during this tumultuous period:

General strategy

- Is my company positioned for sustainable, long-term leadership? Is our strategy clear, and is my team committed to its realization?
- Are we overemphasizing capabilities that do not support our strategic value proposition?

Generation and supply

- Have we formulated long-term, scenario-based wholesale market forecasts?
- How accurate are our predictive models in reflecting integrated market dynamics? Can we dynamically assess the interaction of such elements as carbon, SO_x/NO_x, and forced renewables?
- Are we optimizing our assets into and out of the market as we should — both in the long and the short term?
- Are we operating our assets to optimize availability and utilization? Have we thought about redeploying O&M and capital spend to different assets based on our long-term view of their value under the “green” regulatory agenda?

Transmission and distribution

- Do we have the capabilities in-house to expand and maintain transmission at the levels required to support renewables development?

- Are we leveraging our operating practices and technologies to realize the level of increased “wrench time” we expect?

- Do we have the long-term operating model and skills strategy to support the transition to an increasingly digital grid — and manage on an increasingly real-time basis?

Customer and retail

- Do we have the resources needed to understand, develop, and market products and solutions to help meet new mandates for energy use?
- Are we using technology wherever applicable to leverage predictive analytics to improve reliability?
- Do we have a clear view of the trade-offs between near and behind-the-meter smart grid functionality and net smart grid-dependent benefits?

The corporate center and corporate services

- Do we have a tight governance regime with clear decision rights and issue resolution?
- Do we have a performance-oriented culture that motivates and rewards the workforce?
- Do we have the capacity to analyze performance and plan in an integrated manner?
- Are our transactional functions exploiting scale and efficiency potential?

Designing a capabilities-driven strategy

The changes in each of these areas represent a fundamental transformation of the business rather than simple incremental performance improvements. Successfully navigating this transformation begins by understanding your strategy and what it will take to attain leadership in the future.

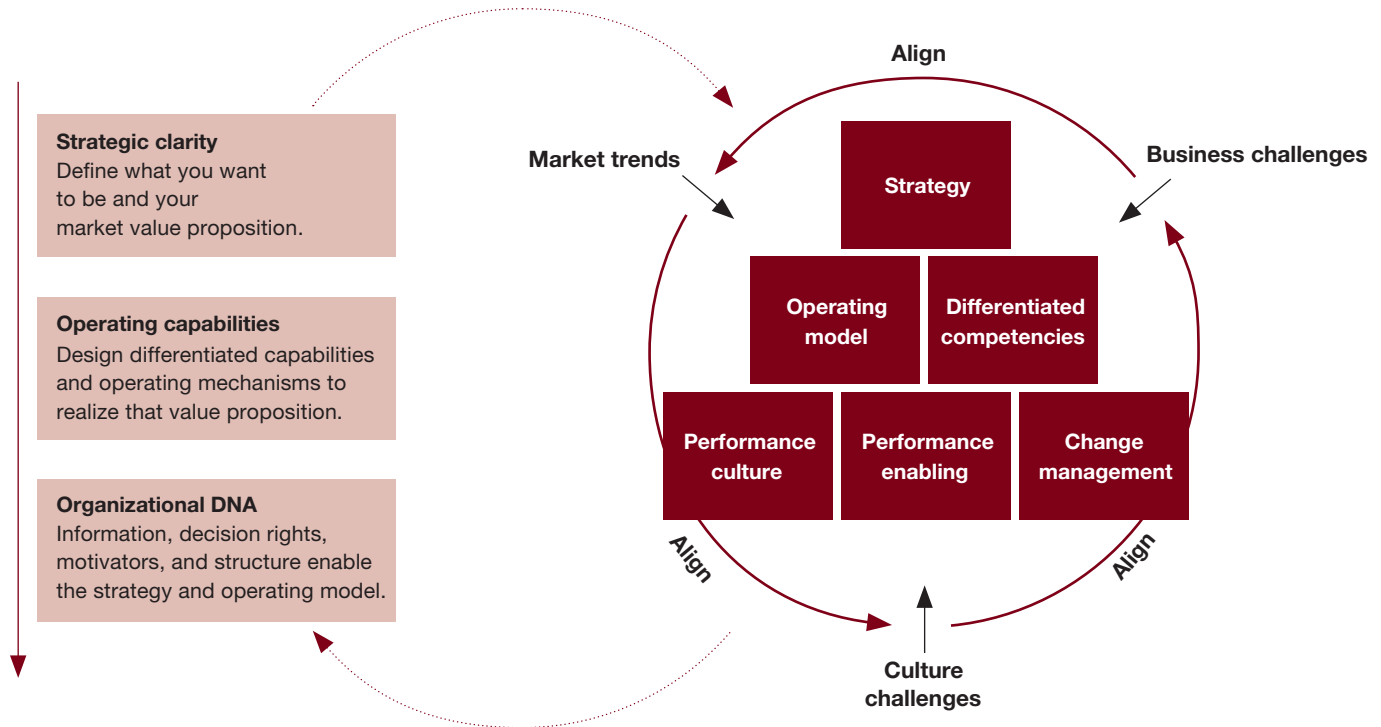
It requires utilities to create a new blueprint for their business, based on strategically aligned capabilities and performance enablers, and then rebuild the business in order to execute that vision (*see Exhibit 2, next page*). The blueprint should be a clear articulation of which capabilities will be emphasized and which will not. It should include an explicit definition of the desired level of capability and performance outcomes, supported by a well-considered skills and staffing plan. Finally, utilities must develop an overall road map outlining how they will realize the aspirations of the blueprint — how they will get from here to there. The process of creating the blueprint must be enterprise-wide and continuous. The blueprint should be written in pencil so that it can be updated and realigned as the market changes. It can be neither rigid nor monolithic.

Companies must look to their strategies to isolate those capabilities with the greatest potential to create value. This requires strategic clarity and specificity. For example, a company looking to become a green power generator might need to strengthen or add capabilities related to the ability to build and link alternative generation sites to urban communities, such as generation and transmission development; emission trading skills to manage the monetization of renewable energy certificates; and regulatory advocacy skills to manage siting, subsidies, etc. On the other hand, if its focus is not on renewables but on demand management, critical skills might be smart grid application development and consumer marketing. In all cases, nonstrategic capabilities would be de-emphasized in favor of the capabilities that better support the company's strategy.

A capabilities-driven transformation is aggressive, setting performance aspirations that essentially redefine the performance

Exhibit 2

The building blocks of organizational DNA underpin strategy and capabilities



Source: Strategy&

frontier (see Exhibit 3, next page). It is more than a traditional or process-oriented change program, in which gains are incremental, performance aspirations are modest, and the elements that enable performance improvement are often missing.

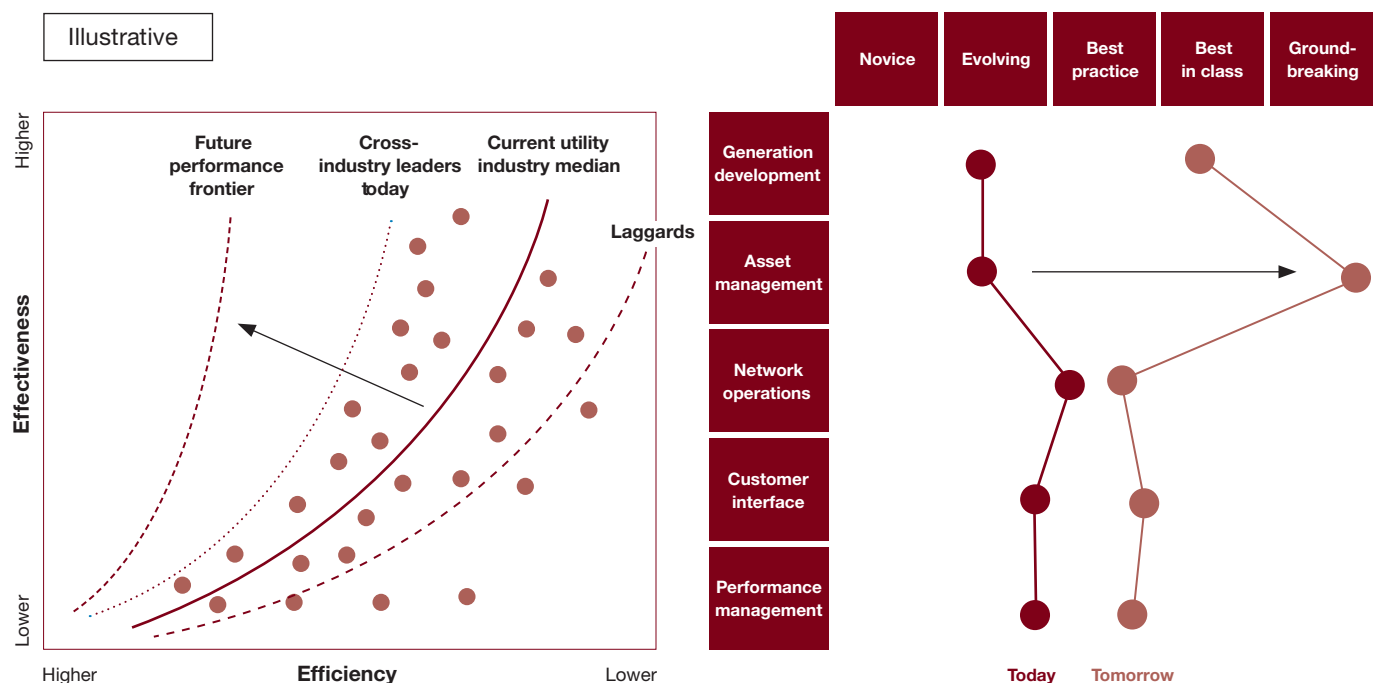
The definition of strategic capabilities, and particularly the target proficiency (for example, distinguished, leading, or just average) of each, forms the basis of an enterprise-wide capability model. This model is the foundation of a unifying business architecture around which senior management should have consensus and ownership. It addresses all aspects of the enterprise — business model structure, integrated process and technology architectures, operating practices, and people and culture — and balances long-term capability building against short-term operational requirements. As with a building's

blueprint, it establishes the structural requirements for ultimate execution, ensuring integration and an explicit understanding of constraints and trade-offs.

Executives are increasingly focusing on these elements of success. Business, in general, is in the era of the architect CEO. It is a role that requires focus and discipline. Trying to be all things to all people, shying away from tough decisions, and succumbing to internal push-back are all ingredients of failure. Those who get it right have established the architectural foundation for success. In the end, leaders realize that a poor strategy executed well is often better than a great strategy executed poorly.

Exhibit 3

The future of performance will be driven by redefined capabilities



Source: Strategy&

Organizational DNA: The foundation that sustains performance

While the translation of strategy into a differentiated capabilities model is vital — and challenging — it is not enough. Market success and performance sustainability rely as much on underlying organizational enablers as they do on core capabilities. Organizational enablers include elements such as governance and decision-making processes, performance management, and talent management. These and other elements make up what we refer to as a company's organizational DNA: areas that companies often neglect, yet are the glue that hold together and empower the diverse capabilities of the enterprise, determining whether it is sustainable, flexible, and responsive or temporary, inflexible, and static.

The building blocks of organizational DNA are essentially performance enablers that support the optimal functioning of core strategic capabilities by ensuring strong planning and resource allocation processes, decision-rights clarity, talent alignment, and long-term — not short-term — motivation. In essence, these building blocks create a dynamic governance and management framework (*see Exhibit 4, next page*). Enabling performance is the most difficult aspect of any performance transformation — and the easiest to neglect. We break performance enablers down into two types.

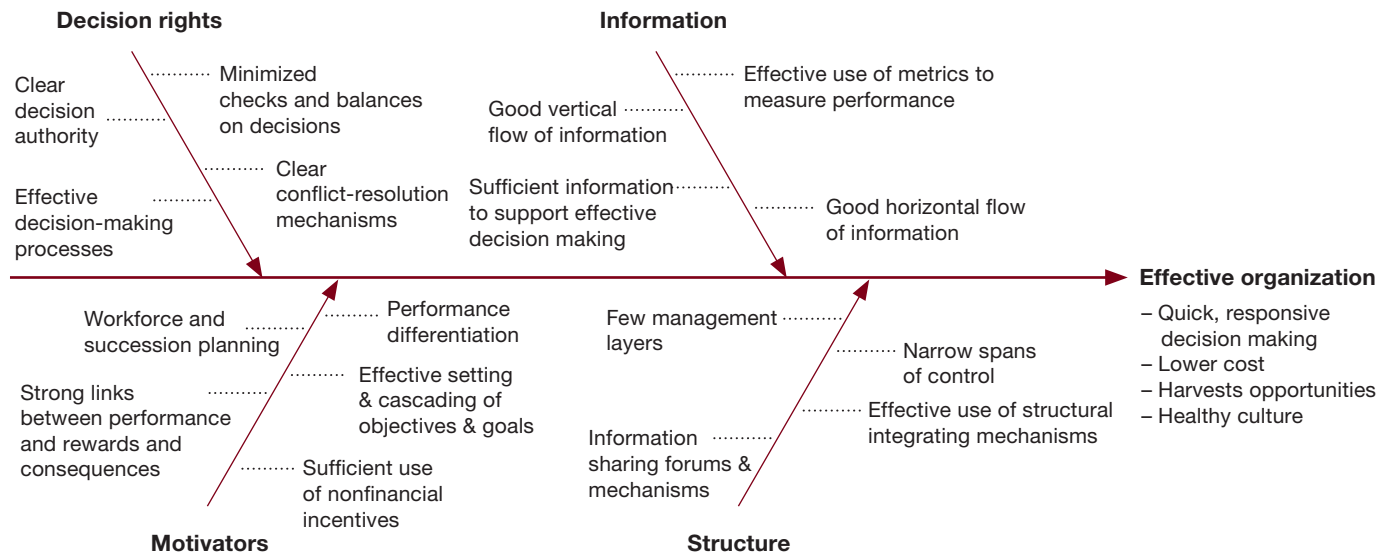
- *Strategic:* Governance, management decision-making, and performance-management elements that drive sustainability and market responsiveness.
- *Foundational:* The people, culture, and technology elements that enable core differentiated capabilities.

In terms of strategic enablers, our research shows that the fundamentals of good execution start with clarifying decision rights and making sure information flows where it needs to go. The four building blocks of strategic execution — decision rights, information, structure, and motivators — are inextricably linked. If you get decision rights and information in line, the correct structure and motivators often become obvious. Unclear decision rights not only paralyze decision making but

Organizational DNA determines whether an enterprise is sustainable, flexible, and responsive or temporary, inflexible, and static.

Exhibit 4

The root causes of organizational effectiveness



Source: Strategy&

also impede information flow, divorce performance from rewards, and prompt workarounds that subvert formal reporting lines. Blocking information results in poor decisions, limited career development, and a reinforcement of structural silos. Organizations with strong strategic-enabling processes typically exhibit five key traits.

- Everyone has a good idea of the decisions and actions for which he or she is responsible.
- Important information about the competitive environment gets to corporate quickly.
- Once made, decisions are rarely second-guessed.
- Information flows freely across organizational boundaries.
- Field and line employees usually have the information they need to understand the bottom-line impact of day-to-day choices.

Foundational performance enablers are more familiar but no less difficult to put in place. Utilities in particular face a steep challenge. At the core of foundational performance enabling is the transformation of the enterprise from an entitlement culture to a performance culture. Leading organizations establish the right motivators to cultivate talent. In particular, human capital capabilities are under great pressure in the utilities industry to address not only the growing demand for broader expertise but also the generational change looming as the workforce ages. To this end, they are incorporating best practices put to use in other industries, such as proactive talent management, reinvigorated training programs, personalized performance measures and awards, nonmonetary rewards for exceptional performers, and the encouragement of lateral moves and rotations.

While there is no single performance model that is right for every utility, it is safe to say that no part of the business is immune from potentially radical redefinition. New market and regulatory requirements, new technologies, and more sophisticated customers are all working in tandem to redefine what utilities do and how they do it. Every management team will be challenged to build new skills and organizational capabilities across the value chain to meet these new market challenges — and to tie them seamlessly into their capability model.

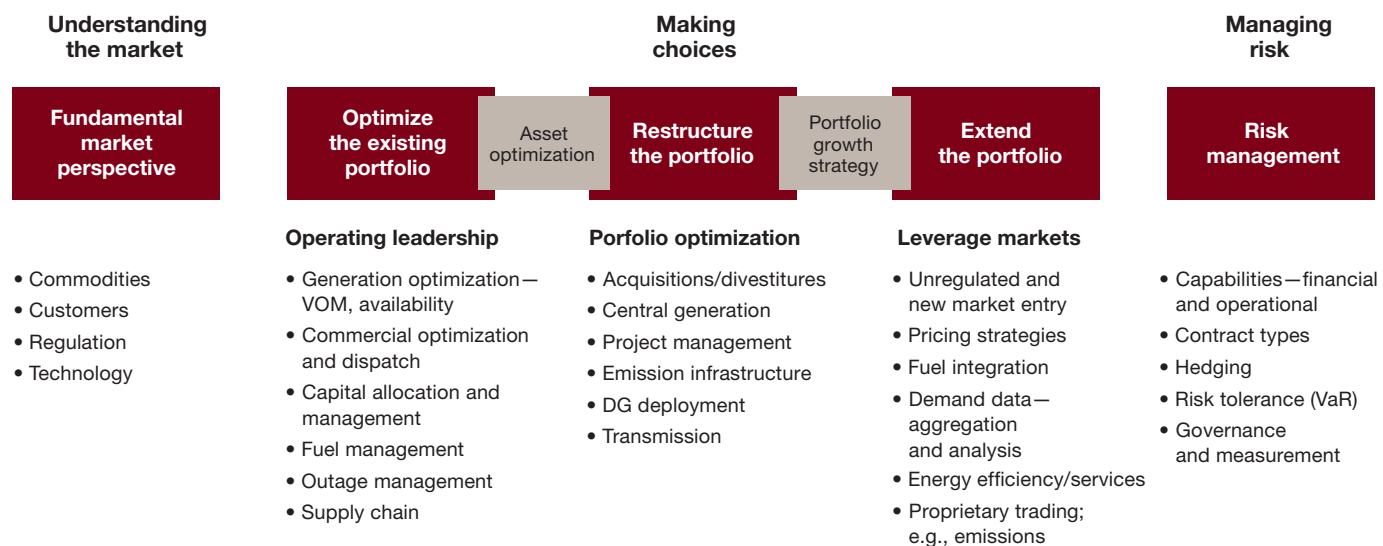
Generation: A new era of asset development and optimization

The utility industry is entering a new era of aggressive supply build-out and optimization, characterized by increasing focus on fundamental market forecasting, regulatory-savvy portfolio planning, project development, and market and plant operating optimization (*see Exhibit 5, next page*). Regardless of the hesitancy stemming from memories of the last market boom-bust cycle, current capabilities and tolerance for risk are largely inadequate. Much more sophisticated forecasting and decision-making capabilities are needed to insightfully assess how power, gas, and emission markets interact in an environment likely to be increasingly distorted by regulation. Five capability themes are emerging.

- *Portfolio strategy*: A formal, continuous re-rationalization of upstream/downstream assets and contracts, including M&A.
- *Market forecasting*: Increasing emphasis on more sophisticated fundamental market analysis and more insightful analysis of interactions and trade-offs.
- *Project development and management*: A decreased reliance on outsourcing of new generation capacity development and the downward management of contractual and execution risks.
- *Asset optimization*: An expansion of capabilities to monetize positions and create appropriate supply and banking strategies around energy commodities, emissions, and various renewable credits.
- *Generation operating performance*: Increasing focus on core performance to generate improved internal cash flows.

Portfolio strategy decisions, in particular, will have large impacts on shareholder value and prove particularly complex. The market uncertainty underlying climate change, pressures in the commodity fuel market, and new generation and demand-management technologies will put an increasing premium on integrated decision making to achieve supply diversity and balance.

Exhibit 5
The pillars of wholesale value generation



Source: Strategy&

Utilities will need to more insightfully assess which assets to build, sell, and maintain in generation and transmission, as well as on the demand side. This process will have to advance beyond physical integrated resource planning to more integrated, scenario-based portfolio planning based on total economic optimization.

Crafting a winning strategy will require a much more dynamic and fundamentals-driven approach to economic optimization than is typically available from traditional deterministic, dispatch-oriented wholesale models. In addition, utilities will have to rebuild their ability to oversee large-scale capital projects in order to manage execution risk and make the best use of project financing.

Perhaps somewhat controversially, we anticipate an increasing emphasis on commercially oriented asset optimization capabilities, such as limited proprietary trading, fuel hedging, and wholesale origination, to extract additional value from the supply portfolio. Despite the fears of the merchant years, most utilities require a base level of merchant commercial capabilities to eliminate the “leakage” of asset value into and out of the market and to monetize increasingly fungible emissions and renewables credits that will be trading in the market.

With mounting pressure on earnings, operating performance will also regain prominence. Generation is the single biggest expenditure for a typical utility, eating up more than half of all O&M and capital spending budgets. There is significant operational variability across and within fleets; best practice transference in areas such as reliability analysis, outage planning, heat rate optimization, and the increased use of predictive maintenance can trim O&M and capital spending by 5 to 15 percent.

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Network delivery: The emergence of the digital, intelligent network

Utilities spend in excess of US\$35 billion and use more than 120,000 skilled employees and contractors to expand, replace, and maintain their delivery infrastructure each year. These amounts are poised to increase rapidly as smart grid functionality extends the capabilities of backbone advanced metering (AMI) and distribution automation (DA) infrastructure. Regardless of the actual pace of this deployment, the core delivery business is reaching an inflection point that will transform how utilities leverage and manage the distribution grid.

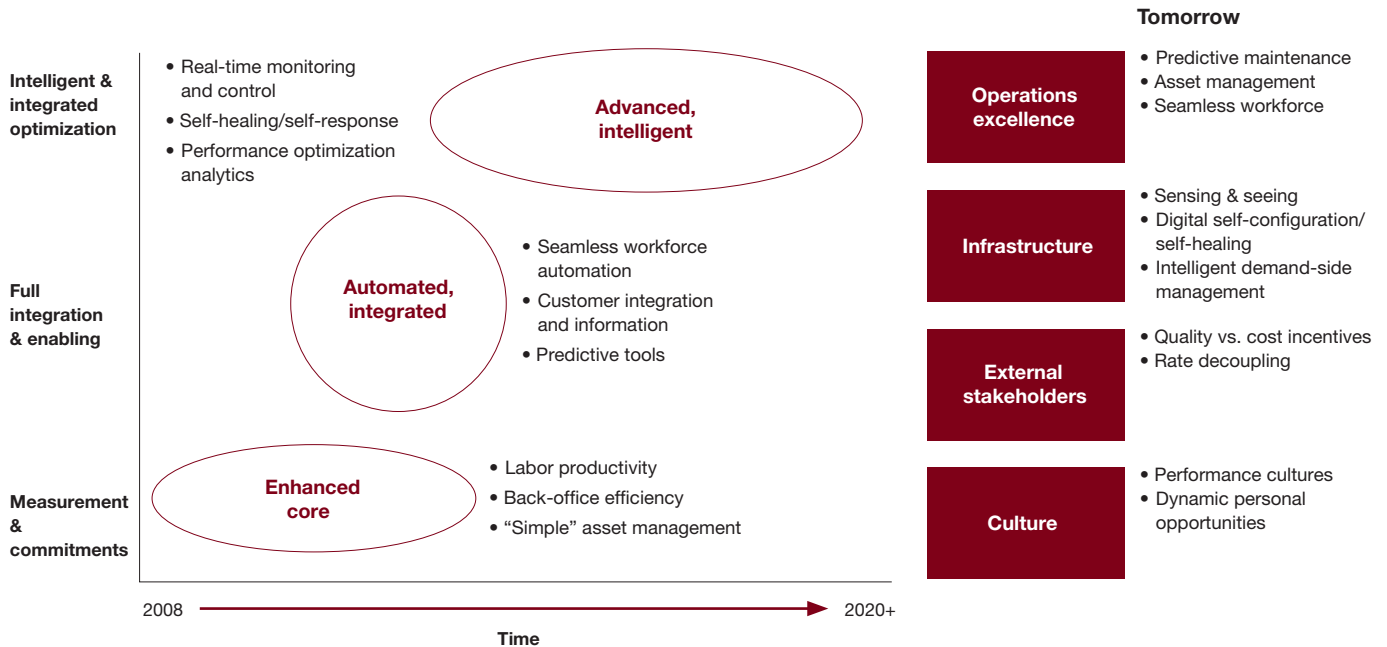
The digitization of the grid will radically redefine how utilities operate and the capabilities needed. One of the most difficult management challenges will be determining where — and where not — to deploy new infrastructure and technology. The temptation to overinvest in the smart grid is great. Properly assessing the costs and benefits requires a comprehensive view of how utilities will operate the network — and how the impact of benefit duplication and cannibalization lowers the point of diminishing returns.

The redefined transmission and distribution business will be characterized by increasingly predictive capabilities, as well as improved real-time information and decision tools (*see Exhibit 6, next page*). The opportunity is substantial and will demand the development or redefinition of capabilities in five key areas.

- *Asset management*: Asset management will increasingly be differentiated from field operations, with the asset management capability evolving to an operating leadership role.
- *Process ownership*: Increasing end-to-end process ownership across geographic organizations will ensure standardization and best practice consistency.
- *Predictive maintenance*: Life-cycle asset management will drive improved resource targeting using predictive maintenance practices, rather than preventive practices.

Exhibit 6

The utility of the future is intelligent and integrated



Source: Strategy&

- *The intelligent worker:* Better real-time management of workflow will increase productive wrench time by as much as 20 percent.
- *Customer-aligned service levels:* Field responsiveness will be more closely tailored to customer expectations as utilities make better use of customer insights and abandon one-size-fits-all service models.

Customer and retail: Customer insight and a marketing renaissance

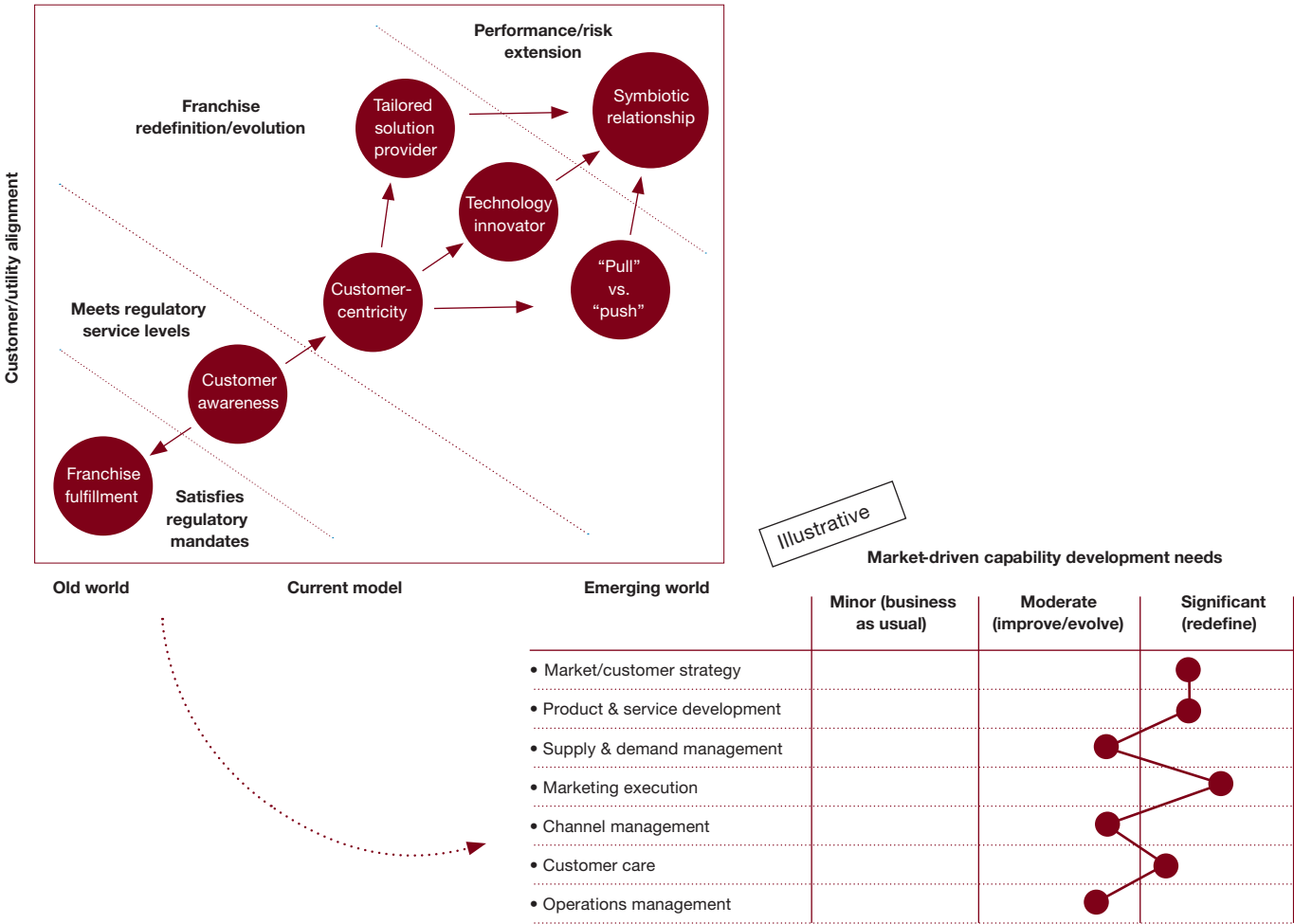
Demand-side mandates and the compelling economics of many demand-management options will accelerate the transformation of utilities' traditional customer-service capabilities into those more akin to cross-industry consumer and industrial marketing organizations. Historically, utilities have treated all customers in a similar fashion, characterized by largely undifferentiated service, few channels, little customer-specific information, weak integration with field service fulfillment, and limited billing and collection options. Utilities' forays into energy services, which have been mixed at best, highlight the challenge.

Fully realizing demand-management potential will require the development of a sophisticated customer marketing capability (see *Exhibit 7, next page*). Its importance in the organization will rise, suggesting the more frequent appointment of chief marketing officers who will guide marketing and integrate customer service as a tool of the marketing mission. A number of capability themes will come to the forefront.

- *Customer insight:* Utilities will place an increasing emphasis on customer knowledge and insight, beyond the demographic and “firmographic” data typically available today. They will focus on segmenting buyers by value-based segments to better understand behavioral motivation and preference triggers.
- *Product development and management:* Utilities will develop the necessary organization and resources to create and manage their product offerings, as well as more effective pricing and sales strategies and tactics.
- *Marketing effectiveness:* Utilities will increase the diversity and sophistication of their channels, including greater use of low-cost channels, outbound marketing, and alliance networks.
- *Customer-oriented service:* Core customer service will be more extensively integrated with broader marketing strategies via

Exhibit 7

Customer and market operating models



Source: Strategy&

cross-selling, real-time access to customer information, and integration with work scheduling.

- *Integration of marketing and resource planning:* Demand management will be fully integrated into resource scenario planning as utilities abandon the siloed “throw it over the wall” mentality.

In the end, the customer organization will evolve into a marketing organization, elevating its position within the utility as a distinct business segment alongside generation and network delivery. For years, leading utilities and energy retailers have been adapting cross-industry lessons to refine the customer experience and improve marketing effectiveness. That practice is only going to expand, and in the not-so-distant future, customer marketing capabilities will become crucial to a company’s ability to be competitive.

The marketing organization will elevate its position within the utility as a distinct business segment alongside generation and network delivery.

Corporate services: Evolution to strategic partner

As discussed, a fundamental requirement for sustainable, leading performance is strong organizational DNA and associated performance enablers. Clear roles and responsibilities, insightful and responsive decision making, strong people processes, and the attributes of a performance-oriented culture are all important. Utilities, in general, have historically not placed significant emphasis on either their strategic or their foundational performance enablers. To meet the challenges of the changing market, however, it is imperative to break this historical tendency. To date, the industry has been relatively slow to respond to the need for this change in focus.

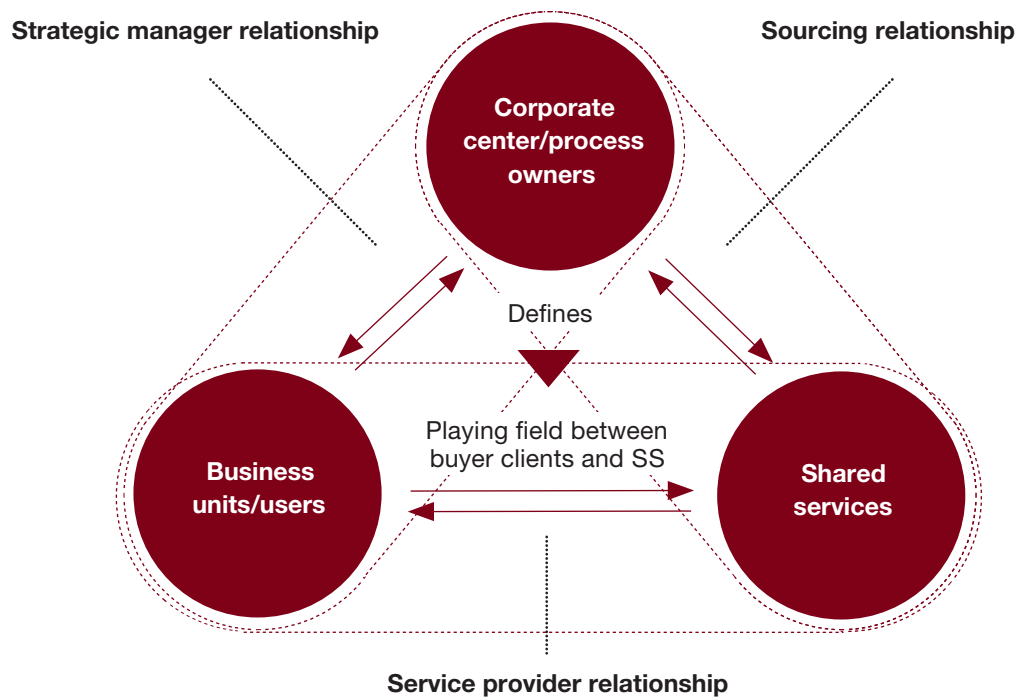
Corporate services will increasingly transform from a transactional service provider to a strategic partner — one focused on performance analysis and decision support. The measure of performance will be how well senior corporate center executives team up with the CEO and line organizations to provide deeper business insight, more comprehensive strategy and policy development, and faster, better-integrated decision making. The objective will be to shift the focus from transacting to strategy, increasing corporate services' focus to approximately three-quarters decision support and performance analysis, as opposed to 20 to 30 percent today.

Aspiring leaders will more aggressively leverage leading shared-services concepts, including end-to-end process ownership, the separation of strategic and expertise activities from transactional or “factory” activities, and the adoption of shared-services management techniques (see *Exhibit 8, next page*). Corporate services will use simple service-level agreements (SLAs) to define their relationships with users, and will use active demand management and clear cost and pricing signals to promote transparent business trade-offs and a better alignment of demand with economic need. Leading corporate services organizations have strong capabilities in eight key areas.

- **Governance:** Corporate services should be managed like a business, as opposed to a fixed cost. It should be an independent unit with senior executive leadership and clear end-to-end process ownership.

Corporate services should be managed like a business, as opposed to a fixed cost.

Exhibit 8
Defining the shared-services organization



Source: Strategy&

- *Skill segmentation*: There must be a clear delineation between routine, repeatable factory functions and expertise functions.
- *Customer orientation*: Corporate services should treat business units like customers, providing them with the service levels they want, not the levels the staff thinks they need.
- *Demand management*: Corporate services should actively drive demand destruction, with internal client demand determining the size of the function rather than vice versa.
- *Service management*: Service levels should be actively managed and guided with limited, focused SLAs; performance accountability should be maintained through key performance indicators and reporting.
- *Price transparency*: Each service should have its own price, with clients determining how much service they want at that price; pricing provides insight into service cost drivers.
- *Efficient delivery*: The services footprint should be consolidated to raise utilization without service erosion; scalable delivery models support flexibility and growth.
- *Skill-based workforce*: Greater emphasis should be placed on analytic skills in the workforce, with workers interpreting and assessing rather than processing and controlling.

Developing the transformation vision

Utilities need to undergo a radical shift in the way they think about performance if they are to fundamentally redefine the standard of competitive leadership in the industry. Most companies, however, have addressed this need with narrow, incremental improvement programs. They tweak the organization within a weak framework for the business and operating model, thus providing little lasting change. These traditional approaches focus on historical benchmarking and incremental process and organizational change. True and sustainable success, however, depends on a comprehensive, integrated, and systematic alignment of the organization around strategy, capabilities, and performance-enabling organizational DNA. Failure to develop any one of these elements can be fatal in the long term.

Skeptics will say that predicting the future is an exercise in uncertainty, while the underlying pursuit of performance leadership is timeless. In principle, this is true. Transformation is not new — but a capabilities-based approach to redefining performance, with an eye to the current climate in the industry and a basis of educated assumptions about its development, is a radical innovation (*see Exhibit 9, next page*). It is not easy. While management theory has consistently addressed the question of managing change, most change programs, large and small, fail to reach expectations — or fail to sustain the gains made. With the challenge only getting tougher, utilities will need to move beyond what they have tried in the past.

Exhibit 9

Elements of successful performance transformation

Traditional change programs

- Delegated to middle management
- Incremental cost reduction and/or revenue enhancement—point ideas
- Series of initiatives—many conflicting, disconnected; no unifying vision
- Decision by committee—no deciders
- Hidden from organization—speculation rampant
- Change imposed too quickly—consequences not anticipated, not proactively managed
- Focus narrowly on performance—for example, cost

Transformation

- – Led by committed, active senior executives
- – Focused on lasting, step-changes in value creation—are visionary
- – Comprehensive integrated programs—guided by clear blueprints and action plans
- – Possess tight governance/clear decision making and issue resolution processes
- – Over-communicate
- – Manage change—pace it to the organization's capacity to absorb change
- – Address all elements of organization performance

Source: Strategy&

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