WHY NORTH AMERICAN UTILITIES ARE A SMART BET

EIGHT STEPS UTILITIES CAN TAKE TO CONTINUE SOLID EARNINGS GROWTH

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As utilities in the United States face new competitive threats brought on by the evolving electric grid, an Oliver Wyman analysis shows the industry still has a solid foundation for earnings growth.

With the new smart grid, consumers will have more control and more choices. Consumers can monitor, analyze and adjust behavior based on the large information flow at their disposal. They can choose a range of distributed generation resources (not just solar) enabled by innovative battery storage technologies.

Excitement about the technology is giving way to rhetoric from new market entrants about the power of the new grid to fundamentally change the industry, with dire consequences for utilities. These doomsday predictions, however, are more hype than reality. No doubt, the high-tech grid is unleashing a wave of innovation. But the old grid and centralized resources will still be around as new technologies proliferate.

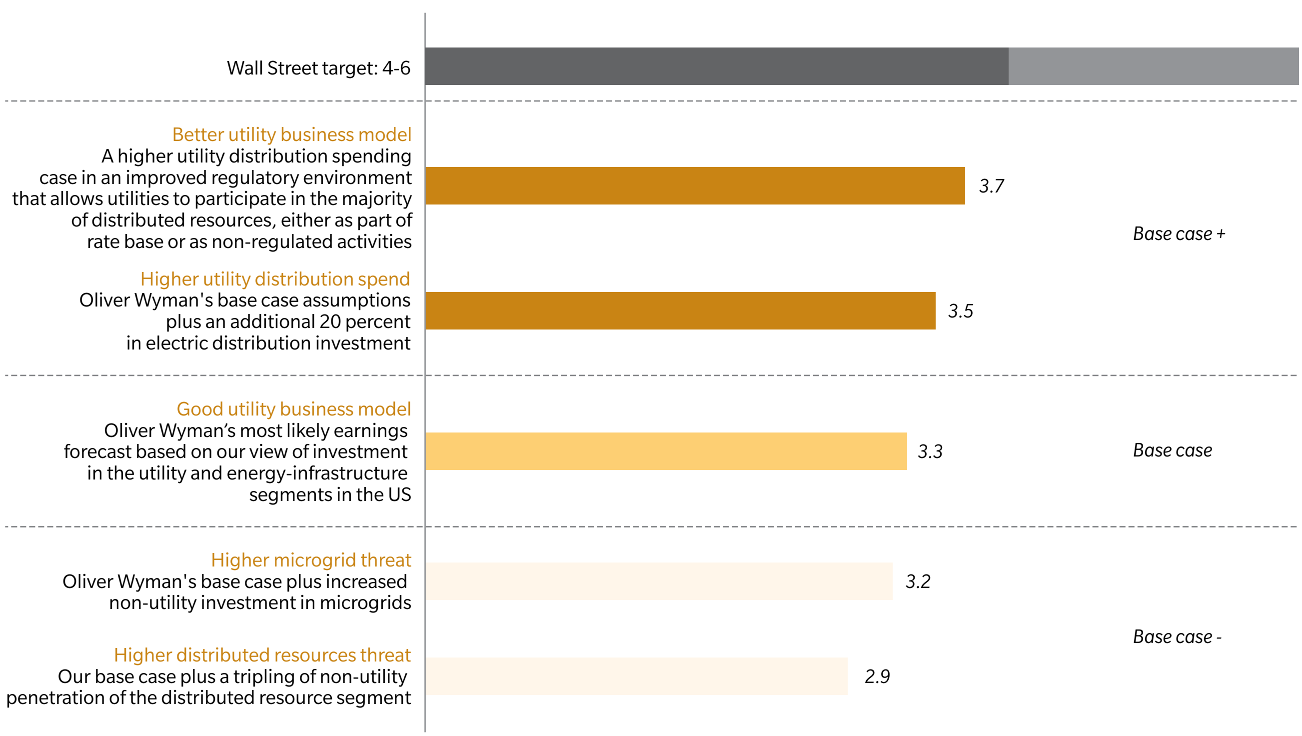
STEADY UTILITY EARNINGS GROWTH

Rather than shrink, we estimate that utility earnings will grow 3 percent to 4 percent

EXHIBIT 1: NORTH AMERICAN UTILITIES EARNINGS GROWTH FORECAST

North American utilities will continue to grow steadily, even if they don't meet Wall Street's current expectations

2014–2030
ANNUAL EARNINGS PERCENTAGE GROWTH



Source: Oliver Wyman analysis. Base case assumes significant and increasing investment in electric distribution, tapering but steady investment in electric transmission and continuing utility investment in a portfolio of generation resources where it is allowed by regulation, offset by a significant increase in non-utility distributed resources and a doubling of gas distribution and transmission capital spending.

annually during the next 15 years for the next decade-and-a-half thanks to requirements for infrastructure investment. While investment in electric transmission may taper off, investment in electric distribution will remain significant and will increase as aging infrastructure is being replaced and a network to accommodate distributed resources is being built. Utilities will continue to invest in power generation in states where they are allowed to do so – both central and distributed resources. And utilities with natural gas businesses are likely to see a doubling of their spending on gas distribution and transmission to enable ample price-competitive gas to reach end-users, including power generation. That's lower than the 4 percent to 6 percent earnings growth that some utilities are forecasting, but we expect utilities could earn even more by making wise changes. (See Exhibit 1.)

With low electricity prices and high performance by most utilities, the majority of customers aren't motivated to seek out something to cut or replace dependence on the local power and light company. The traditional centralized grid will remain relevant, but decentralized energy resources, as their economics improve, will be the new building blocks of future energy resources.

With the bountiful supplies of energy in North America and efficiency measures already in place, we expect electric bills to remain flat during the next 15 years. Average but not improving overall customer satisfaction ratings for utilities are a warning to executives as innovation in the industry heats up, but at a lower decibel.

UNPROFITABLE NEW ENTRANTS

North America has a plethora of new companies involved in residential solar, distributed generation, battery storage, energy services of various shapes and natural gas vehicles, as well as startups in wind, biofuels, ocean energy and other fuel sources. These represent real competition for utilities, but most new entrants aren't profitable.

More than 30 new companies that focus on North America covered by the investment research company Value Line collectively generated about $20 billion in sales in both 2013 and 2014. The median after-tax income margin for these companies was negative 1.3 percent in 2013, and worsened to negative 5.5 percent in 2014. Half had negative cash flows. In contrast, in 2014, the average utility after-tax operating margin 7.5 percent, and every utility was profitable.

> The industry can expect a steady, 3 percent to 4 percent base of growth for the next decade-and-a-half

Of course, the new 1,000-pound gorilla could emerge from the pack, but who that might be may not be clear until much later, say 2040 or beyond. Google represents a strong future competitor, but its acquisition of Nest thermostat technology may be more about developing the connected home rather than the energy market. If Google should figure it out and focus on the energy space, it could present an ominous competitive threat even for utilities.

The utilities' most important stakeholders, regulators, will make some adjustments to accommodate new grid technology, but they will almost assuredly keep the utility framework intact. Certainly public utility commissions and other governmental stakeholders will guide, shape and drive change in the utility market in their attempts to ensure reliable, safe and reasonably priced utility service. But fundamental change to the utility operating model is doubtful.

EIGHT MANAGEMENT LEVERS

The industry can expect a steady, 3 percent to 4 percent base of growth for the next decade-and-a-half thanks to requirements for infrastructure investment. To do better, utilities must pull eight management levers to improve their performance:

1. Undertake solid business planning now. To build a business plan robust enough to capture the opportunities created by all of the challenges utilities face, companies need to design operating and profit models that focus on the new grid, distributed resources, micro-grids, energy storage and other initiatives. Good planning may still be followed by bad outcomes, so a clear focus and commitment in strategic planning to implementation and communication will help set the stage for earnings growth.

2. Become customer-centric. Our research suggests utilities that deliver exemplary customer focus earn 50 to 100 basis points more than those with less customer focus. Happy customers lead to more responsive and flexible regulators, which lead to greater opportunities to achieve higher levels of earnings. The days of putting the company first, speaking from a script and talking at customers are over. Customers want to buy from companies that show empathy, have conversations with them and make eye contact. Consumers will be open to leaving the utility if new entrants are able to show they are truly customer-centric.

3. Use natural gas expansion to focus on customers. The US will be awash in natural gas for a good while. Many utilities also have a natural gas distribution business. What better time to make it easy for utility customers to convert or expand their use of natural gas?

4. Position for increased electric transmission and distribution investment. The infrastructure is more than aging, and could use more investment than is planned. Utilities must set the customer and regulatory stage to accelerate investment in the future, including capturing the value from distributed resources.

5. Expand participation by taking the regulatory initiative. Utilities have delivered big time to both their customers and regulators. They need to tell their story. Be a leader with the state executive branch, the legislature and big-city mayors to infrastructure investment in innovative ways.

> The old grid and centralized resources will still be around as new technologies proliferate

6. Develop a fresh approach to non-regulated activities and business models. The last round of energy retail and wholesale deregulation went down in flames, capped by the Enron fiasco. If non-regulated earnings growth is needed, do not repeat those mistakes. Avoid embracing non-regulated initiatives if you do not have a snowball's chance to execute effectively and sustain profitability.

7. Focus on cost management to earn allowed returns. The average utility does not earn its allowed return on equity. To earn their allowed returns, utilities would need to

reduce non-fuel operating and maintenance expenses by about 10 percent annually. For many utilities, trying to hold expenses flat represents a good first step. The future business environment may require more.

8. Reconsider mergers and acquisitions, especially small acquisitions. Go after the big utilities if you can make it work. But remember, there are still more than 200 small utilities with a $30 billion rate base and $1.3 billion in annual earnings that could fit nicely into growth strategies.

A SMART BET

Utilities are still a smart bet for the new grid. Though it will be challenging, pulling the right management levers smartly should lead to outstanding financial performance. Good utility management working well together provides the best chance to change and succeed.

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