RETAIL SERVICES: OPPORTUNITIES UNLIMITED

FOR

HARVARD ELECTRICITY POLICY GROUP

STRATEGIC PERFORMANCE MANAGEMENT
October 28, 1994

ZAUSNER'S TOP FIVE UTILITY MYTHS

I. Electric industry is different than airlines, natural gas, telephones

II. The longer we delay, the better

III. Our competitive advantage is in vertical integration

IV. Electricity is a commodity

V. Avoiding writedowns will protect shareholder value

UNBUNDLING LIMITS THE VALUE OF VERTICAL INTEGRATION-- IT'S THREE DIFFERENT BUSINESSES

Drivers → Electric Utility → Strategic Implications

- Bypass
- Self-Wheeling
- Unbundling
- Retail Wheeling

→ **Distribution** →

<u>"Fight for Hearts, Minds, and Wallets of Customers"</u>

- Regulatory Hybrid
- Middle Mkt. Share Fight
- Stranded Service
- Differentiation Wars

- Open Access
- Comparable Service

→ **Transmission** →

<u>"Only Natural Monopoly Left"</u>

- Unbundle
- Maximize Regulatory Value

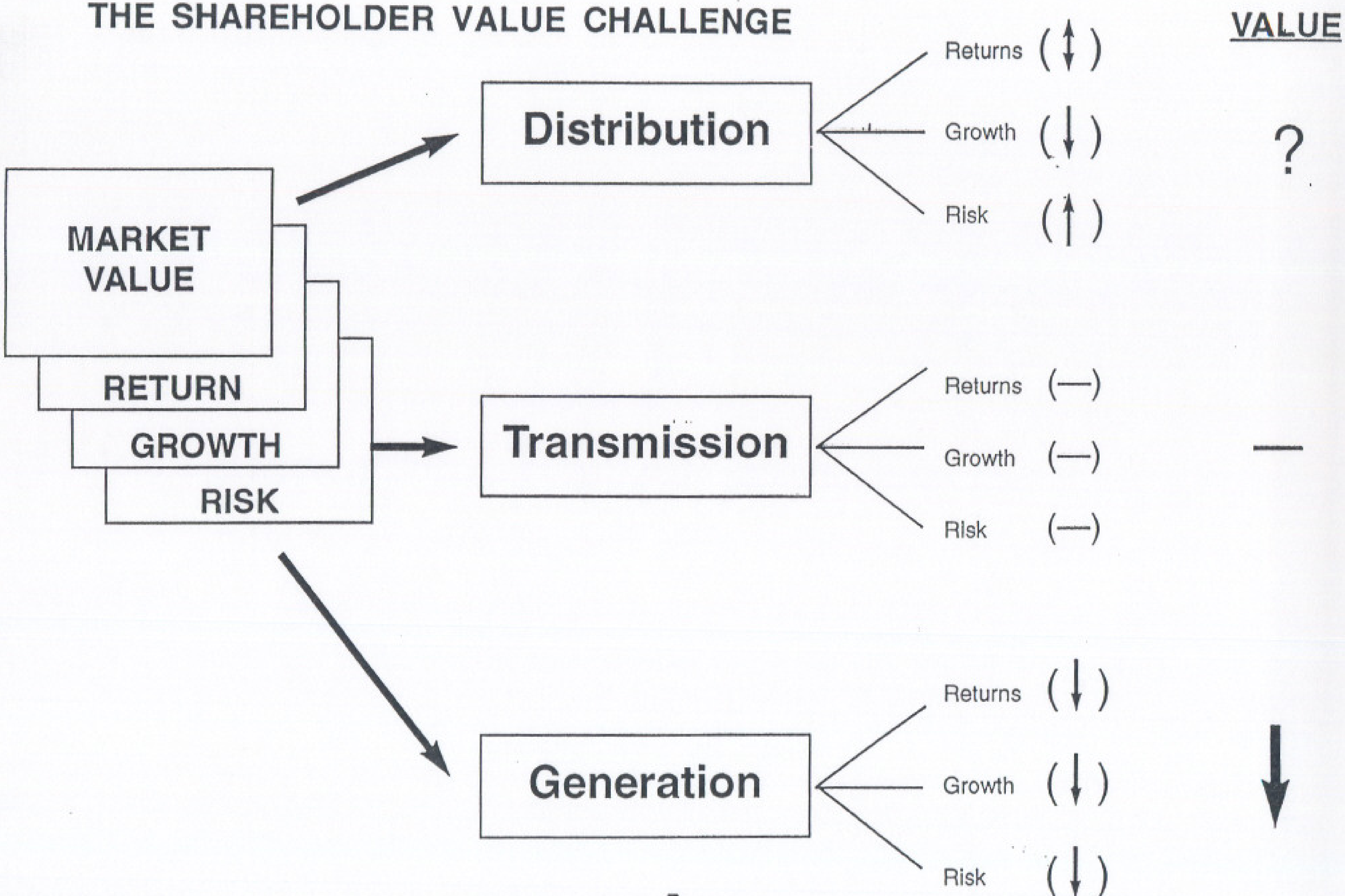
- Bidding
- Wholesale Markets

→ **Generation** →

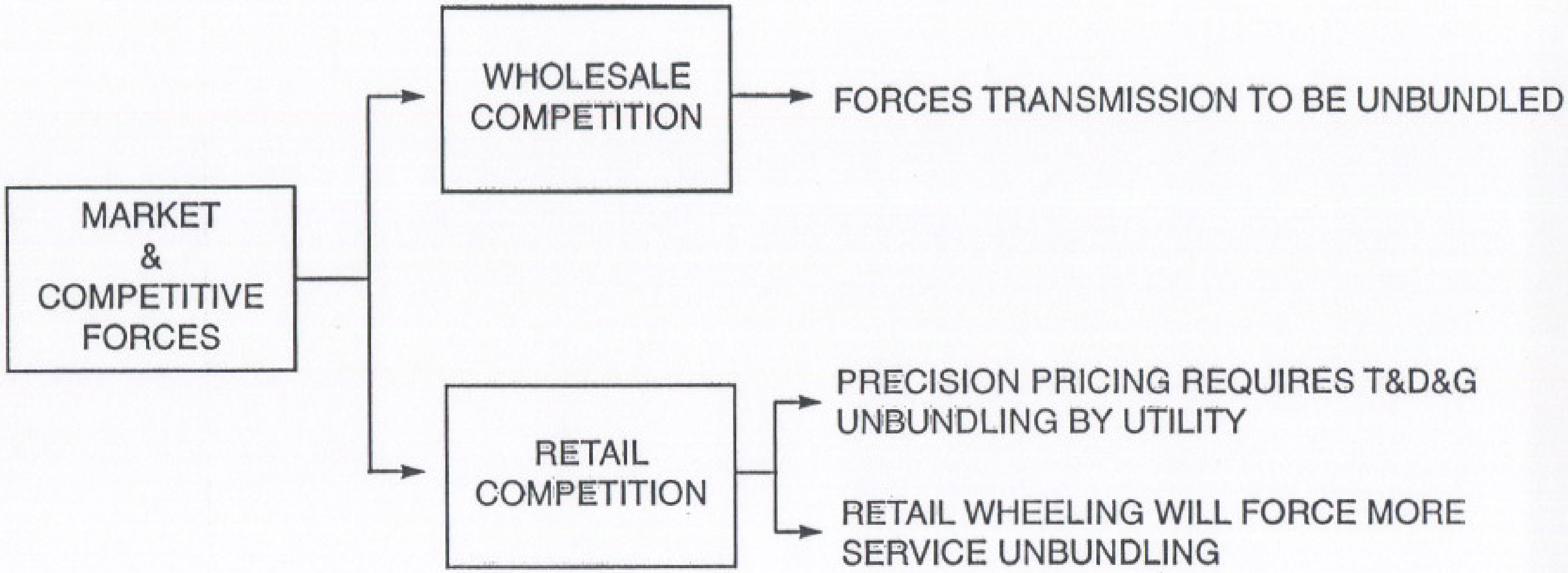
<u>"Simple Business, That Few Will Like"</u>

- Commodity--Low Cost Wins
- S.T. Blood Bath
- Market Restructure
- Industry Consolidation

THE SHAREHOLDER VALUE CHALLENGE



EXTERNAL DRIVERS FORCE UNBUNDLING



- BYPASS
- MUNICIPALIZATION
- SELF WHEELING
- RETAIL WHEELING
- DIRECT ACCESS

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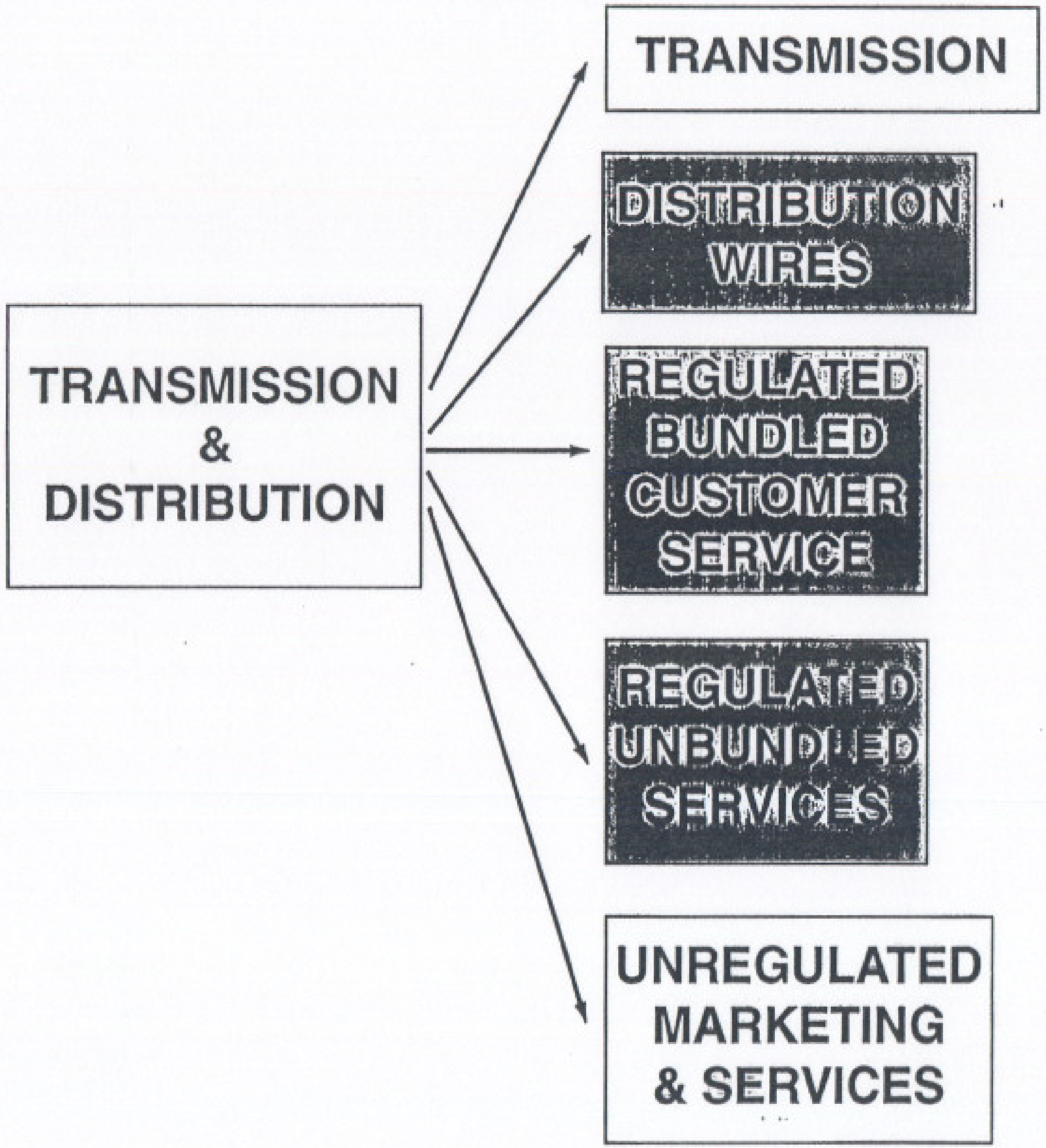
HENCE THE T&D BUSINESS WILL BECOME FIVE BUSINESSES



TRANSMISSION
- REGULATED MONOPOLY
- FERC (?)

DISTRIBUTION WIRES
- OPERATING/SERVICE COMPANY
- REGULATED MONOPOLY

REGULATED BUNDLED CUSTOMER SERVICE
- REGULATED
- INNOVATE TO MAXIMIZE SHARE RETENTION
- LONG TERM CONTRACTS
- PREMIUM SERVICES/PRICING

REGULATED UNBUNDLED SERVICES
- MIX & MATCH OFFERINGS
- DRIVEN BY RETAIL ACCESS

UNREGULATED MARKETING & SERVICES
- MARKETING, TRADING, ARBITRAGE AND RISK MANAGEMENT
- DSM

DISTRIBUTION HAS MORE DOWNSIDES THAN JUST PROTECTING STRANDED GENERATION INVESTMENT

- Cherry picking of high cost services
- Market share losses that "strand" overhead and capital
- Undermining of customer franchise

THE DISTRIBUTION BUSINESS FACES SEVERAL CHALLENGES TO CREATE SHAREVALUE

- Positioning to preempt or blunt competition
- Maximizing market share and margins
- Innovating new services to create growth

PUT SUCCINCTLY, IT IS TO MANAGE A RETAIL BUSINESS NOT A REGULATED MONOPOLY SERVICE

"THE ONLY THING YOU FIND IN THE MIDDLE OF THE ROAD IS DEAD ARMADILLOS."

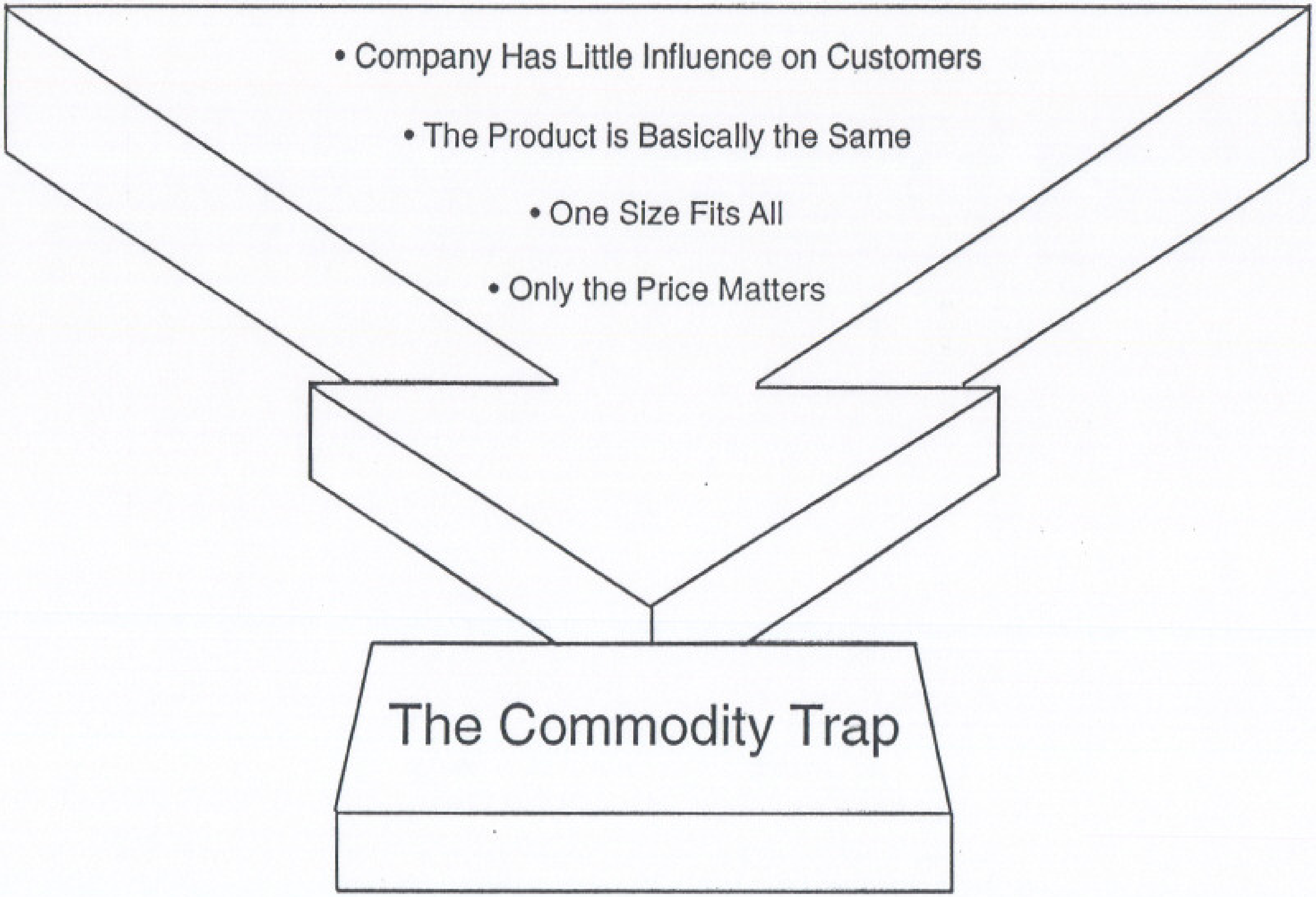
DELAY

- Delay competition
- Protect existing services
- Don't cut costs much if flow through
- "Fast Follower" in new services

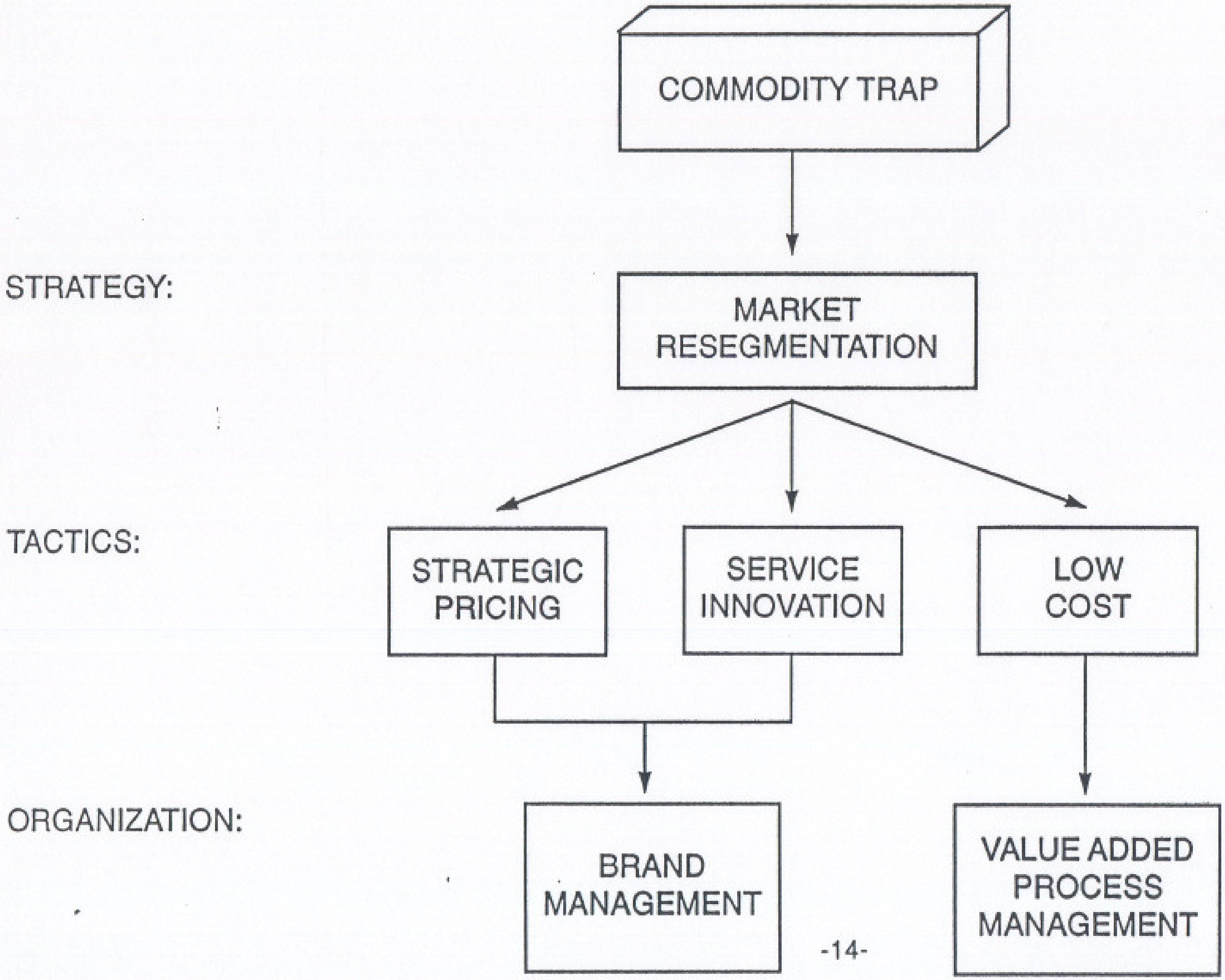
PREEMPTIVE ACTION

- Lead competitive change
- Innovate new services, even if it cannibalizes old ones
- Set prices at competitive levels and make costs follow
- Create a new regulatory compact

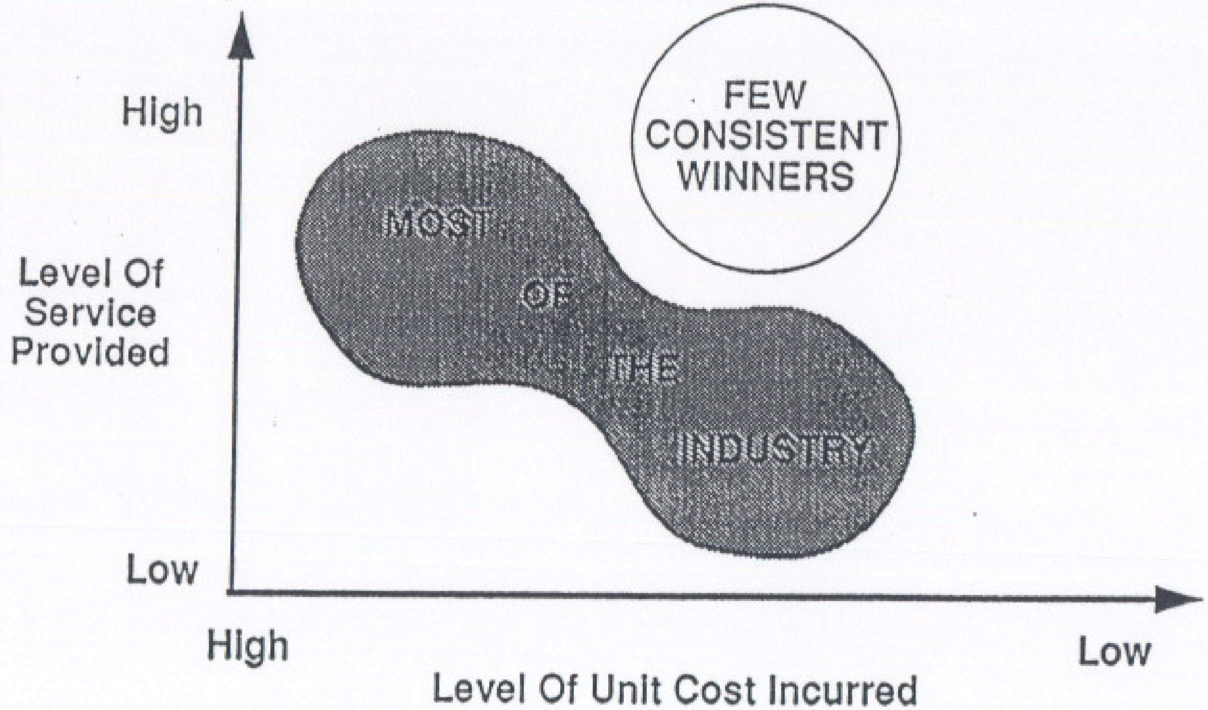
THE RETAILING CHALLENGE IS TO AVOID THE COMMODITY TRAP



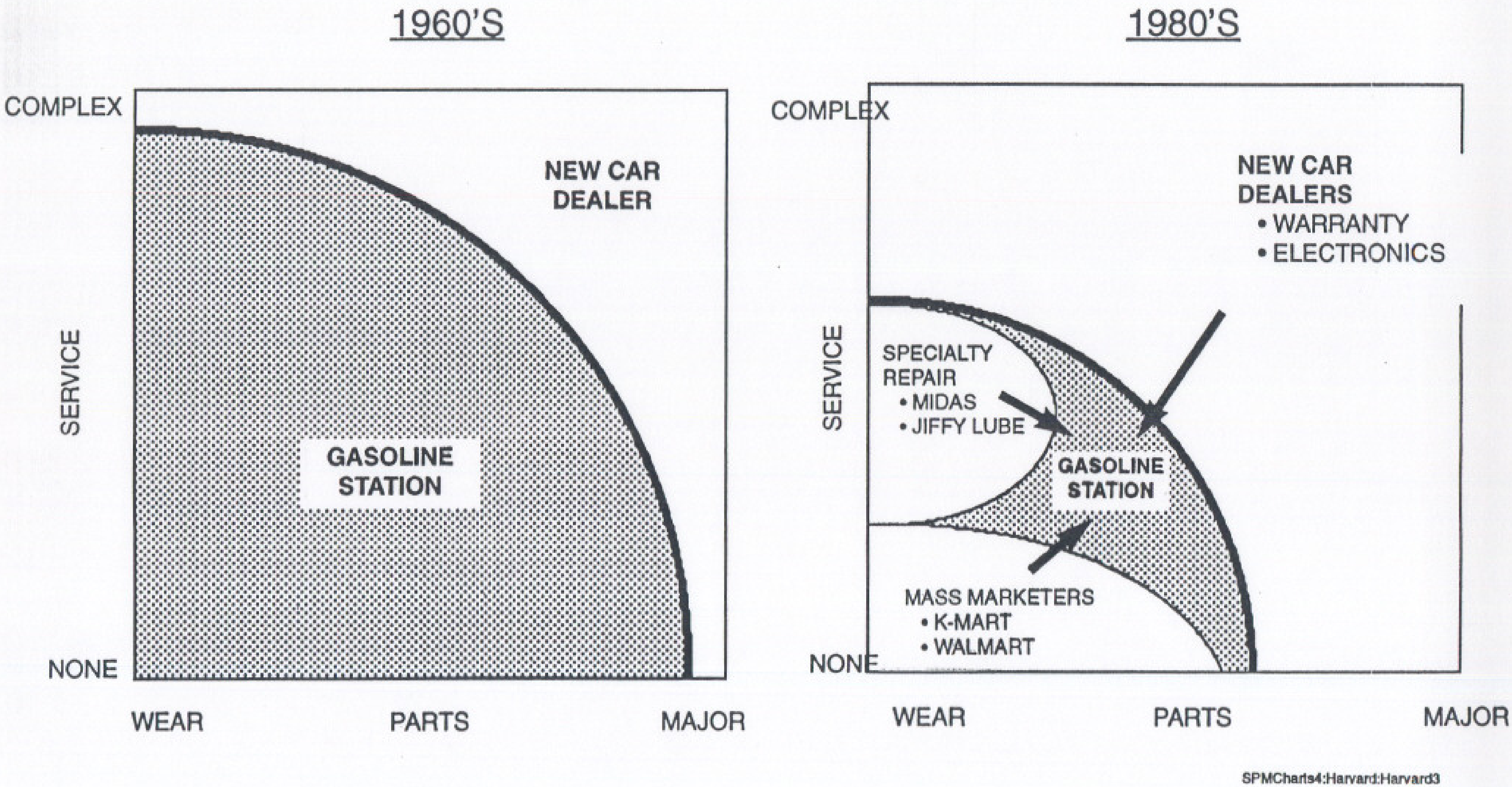
TO AVOID THE COMMODITY TRAP--TAKES THREE ACTIONS--PLUS THE REGULATORY FLEXIBILITY REQUIRED



THE MOST POWERFUL RETAIL STRATEGIES DON'T TRADE SERVICE FOR COST, E.G., SOUTHWEST AIRLINES, FEDERAL EXPRESS, MIDAS MUFFLER OR WALMART

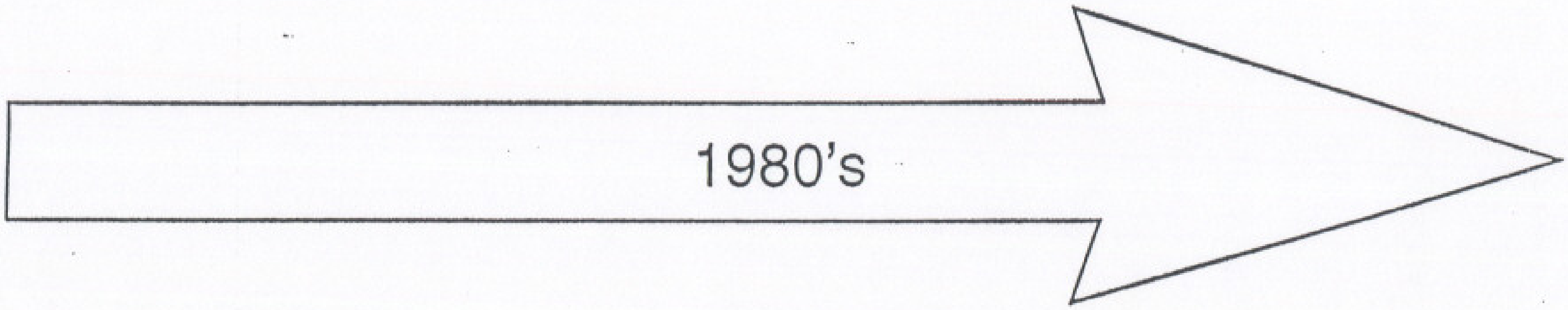


RESEGMENTATION--THE GASOLINE STATION EXAMPLE



WHY: CUSTOMER NEEDS, COMPETITIVE FORCES, COST TO SERVE

STRATEGIC PRICING IS NOT JUST "COST PLUS"



- ONE PRICE FITS ALL
- RATE X MILES = FARE

- SAME PLANE = 10X
- RESEGMENTATION/PRICING
  - BUSINESS (NO ADVANCE & WEEKDAY)
  - LEISURE/VACATION (30 DAY ADVANCE)
  - FREQUENT FLYER (BONUS MILES)
  - LARGE CORPORATE (DISCOUNTS)
  - SEASONAL PRICE (DISCOUNTS)
  - HIGH VOLUME (HUBS OR POINT TO POINT)
  - SERVICE (FIRST, BUSINESS, COACH, NO FRILLS)

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THE TELEPHONE EXAMPLE: SERVICE INNOVATION

1980's

- Monopoly Service
- Bundled Offering
- Commodity Product

- **Unbundled Offerings**
  - Operator Service
  - Inside Wire
  - Information
  - Instrument
  - Long Distance
- **Resegmentation**
  - Frequent Callers
  - WATTS
  - 800 Services
- **Premium, Differentiated Services**
  - Quality
  - Call Waiting
  - Caller I.D.
  - Voice Mail

LESSON #1

REGARDLESS OF APPROACH, THE MAJOR SEGMENT (SOME PORTION OF RESIDENTIAL AND COMMERCIAL) MUST BE POSITIONED AND MARKETED TO REINFORCE/MAXIMIZE THE LATENT DESIRE NOT TO SWITCH OR UNBUNDLE

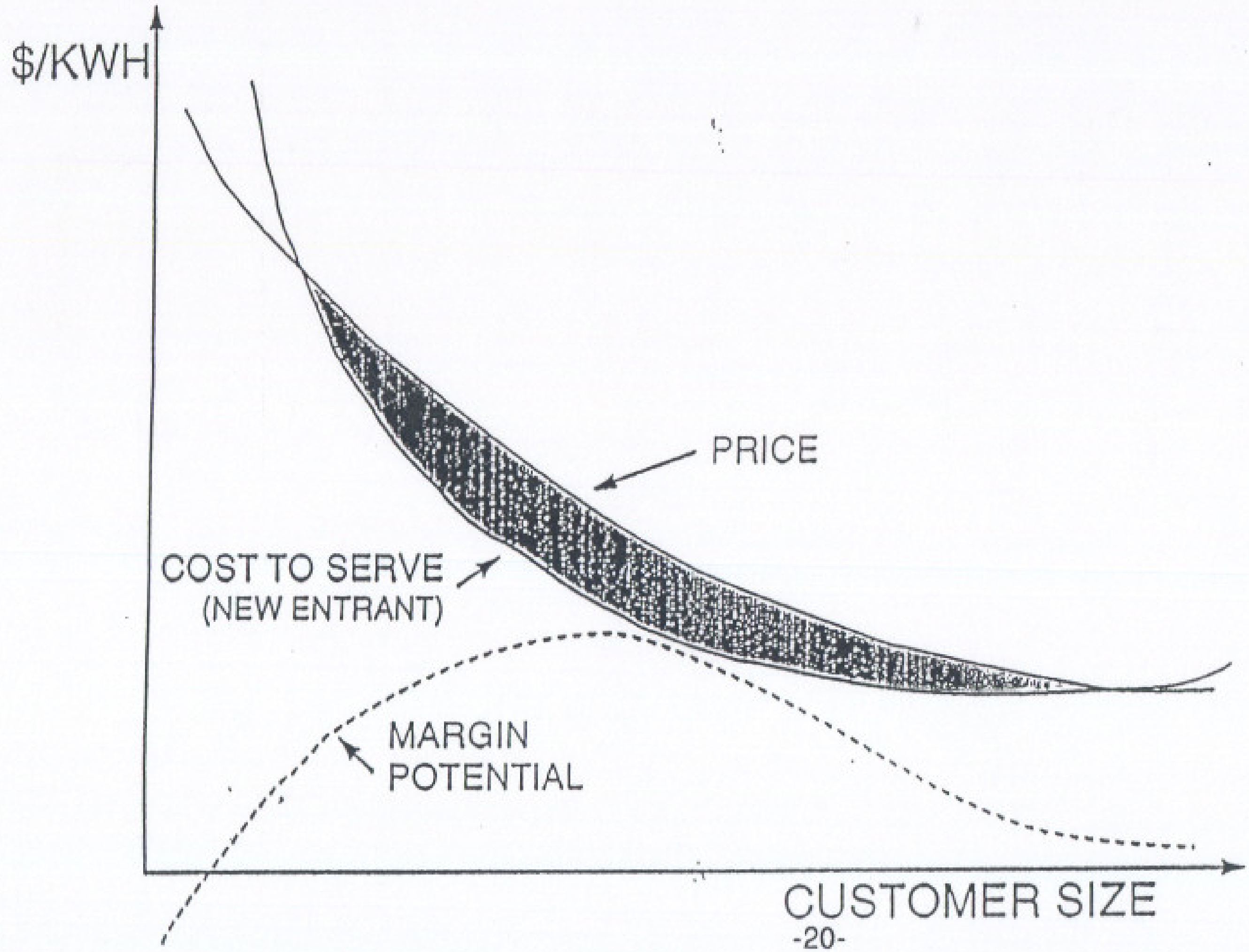
- Too lazy or dumb
- Costs too low to bother
- Wants reliability no matter what

MASS MARKETING IN OTHER UNREGULATED BUSINESS (BY THE ENTRENCHED, REGULATED COMPETITOR)

- "You can depend on us" (Gas Company - California
- "The right choice" (AT&T)
- Etc.

LESSON #2

THE SECOND FOCUS SHOULD BE TO PROTECT MIDDLE MARKET--WHERE MARGINS ARE HIGH AND ACCESS EASIER (LARGE COMMERCIAL, AGGREGATION TARGETS, ETC.)



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LESSON #3

INCREMENTAL VALUE ADDED SERVICES MUST BE AGGRESSIVELY EXPLORED

- To get more profit per incremental $ of cost
- To build barriers to switching

THERE ARE MANY ALTERNATIVES POSSIBLE

- Providing long-term price stability through fixed price contracting or other risk management products
- Making customer side of the meter investments to provide lower cost (and lock in customers)
- Making customer side of the meter investments to expand services (and lock in customers)
    - Power conditioning
    - Emergency generators at hospital, etc.
    - Energy management services (turns lights on and off during vacation, or pre-cool homes, etc.)

LESSONS #4

DISTRIBUTION SHOULD ALSO BE ORGANIZED TO REFLECT ITS MISSION

- Operations (or wires) should be managed discretely and unbundled (at least internally)
  - Determine costs of components, benchmark, reengineered, etc. to be the low cost provider

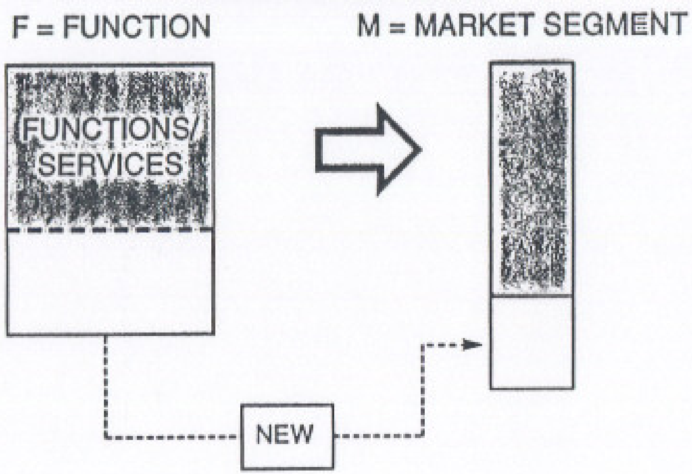
- Customer service should include all customer classes and focus on value added, rebundling

  - Creative resegmentation by needs not demographics
  - Organized by "brand" or segment managers
  - Development of value added products and services for use by brand managers
  - New products/service managers to develop and manage value added offerings

LESSON #5

THE ORGANIZATION MUST REFLECT NEW SEGMENTATION PRODUCT INNOVATION AND COST UNBUNDLING

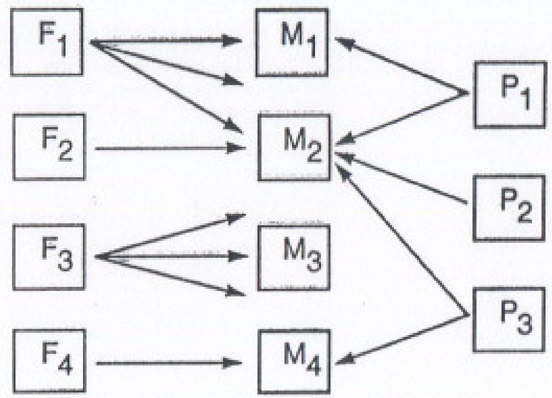
ONE SIZE FITS ALL



IMPLICATIONS

- FIND "COMMON DENOMINATOR" SERVICE THAT MOST WANT
- LOWER COSTS OF BUNDLE
- EXPLORE INCREMENTAL SERVICES AT INCREMENTAL COSTS
- TRADITIONAL UTILITY ORGANIZATION

MIX & MATCH



IMPLICATIONS

- UNBUNDLE FUNCTIONS
- MAKE EACH LOW COST OR OUTSOURCE
- REBUNDLE BY CUSTOMER SEGMENT
- EMBED VALUE IN SEGMENT OFFERINGS
- BRAND MANAGERS, FUNCTIONAL and PRODUCT ORGANIZATION

UTILITY DISTRIBUTION --THE BOTTOM LINE

- Big downsides/big upsides
- Retailing, not a utility
- Resegment, reprice and rebundle