Creating a winning business model

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Primarily through costly acquisitions, Europe's energy companies have sought to take advantage of market liberalisation. But according to Pat Breen, Chief Executive of Gas Strategies (London), we have yet to see a business model with foresight and execution that creates value. Furthermore, the risk is that market constraints and pan-European regulation will stifle opportunities before companies realise how best to exploit them to their advantage.

Setting the scene

In response to the challenges and opportunities of liberalisation and competition, much has been written and debated in the past 10 years on the subject of business models within the European utilities industry.

We have all witnessed serial changes in accepted wisdom as organisational structures have come and gone, as proclaimed strategies have been launched and then left quietly to wither, and as some industry leaders have run off a cliff into bankruptcy.

In this paper, I would like to reflect on the nature of the 'business model' and to dispel the notion that all it takes to achieve a successful strategy is a good adviser and a slick PowerPoint.

What are we here for?

It seems logical to assume that business models are developed as a means by which companies clarify and deliver to a clear sense of purpose.

For formerly state-owned utilities the definition of 'purpose' has evolved in the wake of privatisation and liberalisation. We have witnessed a number of evolutionary stages:

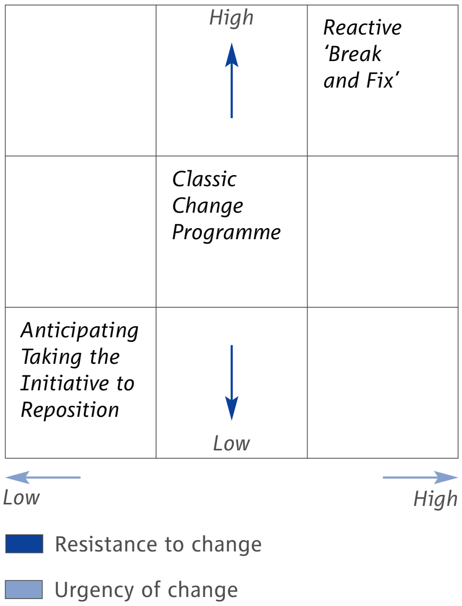
i. Free of a compulsion to adopt a 'pop' management veneer under public sector ownership, companies recognised that their purpose was to *fulfil public energy supply requirements within an agreed budget and policy framework*.

This reflects the public sector origins of most of the European power and gas utilities. Getting people connected, meeting the demands of economic growth and keeping the lights on.

ii. Privatised and operating within a framework of regulated licences, Board objectives evolved to become *achieving superior returns for shareholders through exercising their licence rights and obligations*.

This meant addressing the same public energy supply requirements, but seeking to do it at lower cost. Policy compliance remained a primary obligation, but with a shift in the policy framework to 'outputs' through the process of re-regulation. This is essentially a low risk development founded on cost management within a well understood and 'fat' core business.

Figure 1 – Qualities of foresight



iii. Flushed with the cash flows and self confidence from delivering what were relatively low hanging opportunities, companies then deemed themselves capable of a much greater purpose, namely *to be the (or amongst the) leading energy utility suppliers in the world*.

For some organisations, this evolution in objectives was pro-active, reflecting real understanding of internal capability and opportunities. For others, it was purely reactive, based on observation of others, rather than insight.

Commonly we see 'scale' being the most identifiable 'purpose':

'to be the world's leading power and gas company'

'To be a leading European utility business...'

For those organisations that have endured this evolution, and have managed to remain independent, the purpose is typically more pragmatic:

'to be a leading supplier of essential services in our chosen market, deepening our relationships with customers, achieving cost advantage for our downstream supply, sharing our knowledge and practice'

For others, the purpose remains wide and all-embracing:

'We aim to be the most efficient, market driven, quality focused provider of power and gas, creating value for our customers and shareholders'

Across Europe, privatisation, regulation and market opening are progressing at various speeds. Those organisations operating in markets where change is slow have often felt compelled to jump directly into investing in legacy operations and acquisitions. It seems the bigger they are the more heavily they are compelled to jump.

Cash rich from traditional monopoly operations (like those US companies looking to invest in the UK in the mid-90s) they have acquired businesses without real appreciation of the complexity and challenges involved.

At last year's RWE Trading Symposium in Brussels, I revealed that, based on the evidence of the last five years, the major industry players had destroyed some €80–100 billion of shareholder value.

How would a complete stranger to the industry describe what he sees? Would he see, principally, an engineering community with the same focus on keeping the lights on but the bill now being footed by shareholders instead of government? Would he see a new colony of people with sales and marketing badges playing at being shop-keepers in an artificial market? Would he see colonies of people bringing new skills imported from project finance, equity finance, and trading, intent on self-preservation until the music stops?

Where are we heading?

A business model should be *strategic*. In most cases, this is taken to mean that the business model will provide superior performance relative to those of competitors in the same market.

Developing a successful business model requires the presence of foresight regarding the company's industry: its competitors, customers, suppliers, resources and people.

This foresight needs to be accurate in both its nature and timing. The capacity for foresight also needs to be robust, so that the organisation can keep refreshing its business strategy to meet changing market conditions.

All the people within the enterprise (including its strategic suppliers and customers) need to be 'connected' with the business environment and be pro-active in shaping the organisation to meet future challenges.

The capacity for strategic foresight is quite distinct from high-urgency turn-around or of a ubiquitous 'change programme'. In these instances, a 'business design' is being introduced in order to improve performance – with differing degrees of urgency. However, in these circumstances the qualities that will maintain foresight are fundamentally absent (see Figure 1).

The organisation with true strategic foresight maintains its advantage by recognising early the opportunity for change and pro-actively delivering this change.

Business model effectiveness is not only a matter of 'getting right' a design, but also maintaining the most effective business model, as the market and the enterprise evolve: 'skating to where the puck will be'.

Figure 2 – Example 1 – A major transatlantic gas and power retailer

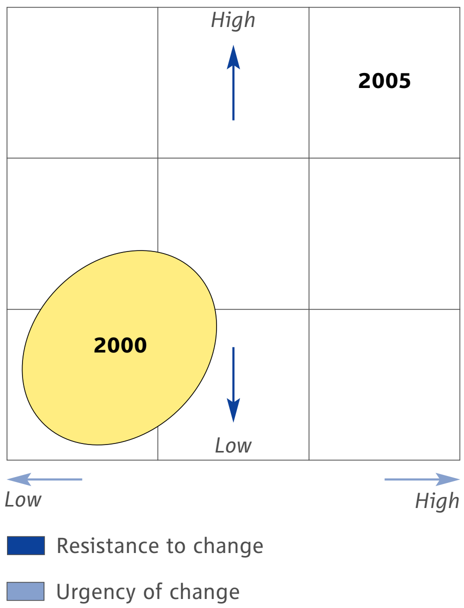
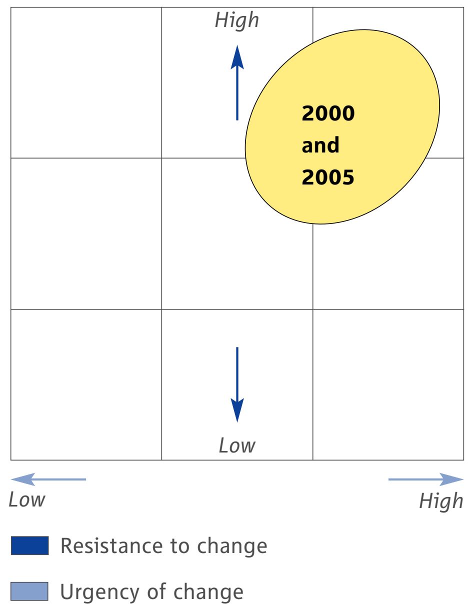


Figure 3 – Example 2 – A major state-owned global power enterprise



The greatest prize awaits the first mover that gets it right. Genuinely fast followers can win where they have the agility to recognise the opportunity at an early stage and then re-position themselves most efficiently.

So what is the evidence of what we can term ‘sustainable foresight’ and what are its practical applications in the energy market?

Example 1 – A major transatlantic gas and power retailer (Figure 2)

Demonstrated and recognised for foresight in establishing its strategy to become a brand leader in home and essential services.

Management focus and enormous investment absorbed in pursuing this strategy. Customer franchise and shareholder value not achieved. Developing an IT capability to achieve the integrated ambition proved elusive.

Enterprise now facing critical challenge of replacing gas reserves. Facing few opportunities and unpalatable costs owing to lack of foresight on core asset diminution.

Example 2 – A major state-owned global power enterprise (Figure 3)

Relatively late entrant to international acquisitions. Perceived to have paid a high price for assets in a competitive buyers’ market.

Management focused on M&A activity without recognisable focus on management of acquisitions for value-delivery.

Enterprise now visibly challenged to achieve a successful IPO without strong track record of business performance.

For both of these organisations, one conclusion might be that they are each struggling because their business model has not continued to evolve.

The transatlantic gas and power retailer has lost its position of foresight. The state-owned global power enterprise had no position of foresight in 2000 and was merely a market follower; it has simply paid a higher price to achieve nothing (to date) other than remaining a market follower.

Another perspective on the essential nature of such foresight is offered if we consider a view on the medium-term future for the European gas market:

Europe and North America now present a significant opportunity for LNG exporters formerly focused on the Pacific Basin. These markets are already linked by LNG cargo diversions depending on where prices are highest. In future, high spot prices in the US could drag more LNG cargos away from Europe, which could, in theory, raise European gas prices.

Not all will be built. Yet the US will still have significantly more terminal capacity than needed through to 2015. Prices in the US gas market will demonstrate significant volatility, at times dipping low enough to prompt LNG producers in Europe, Africa and the Arabian Gulf to divert cargoes to Europe.

Taking Europe in turn: while roughly in balance as a whole for the next several years, there is the potential emergence of significant surpluses in Italy, Spain and the UK. Surplus gas in the UK will prompt lower prices, which the UK can export through the Bacton-Zeebrugge Interconnector and through the BBL pipeline. A similar phenomenon can occur in Italy, serving Germany and France by backing off imported pipeline gas from the north. Spain also forecasts significant gas surpluses. Spain is likely to adjust its position through the onward sale of LNG cargoes. This in turn could influence gas markets in North West Europe, as well as Italy.

The play-out of these US and European scenarios then combines with different scenarios for third-party access development in Europe. In the event that Germany and France make little progress with liberalisation, then the price effects of surpluses will focus more directly on Spain, Italy and the UK. In contrast, successful liberalisation will tend to support gas prices in those countries with surpluses, enabling them to export more successfully their surpluses to interconnected countries. A more modest price-effect would extend across a larger group of countries.

Existing European long-term contracts for natural gas contain price review and price re-opener clauses that can spread the impact of changed spot prices across the industry. In turn, this may lead to structural changes in the way in which continental European medium- and long-term gas supply contracts are structured.

Most power generation and distribution companies in Europe are now significantly exposed to the gas market in both generation and retail markets.

It is not evident that any have developed sufficient sophistication in their understanding and involvement within the gas market to allow them to compete effectively in a market of such growing complexity.

It is unlikely that the informed independent observer would recognise any of the major European power companies as having demonstrated foresight on potential future scenarios within the European gas market, or as having developed strategies and supporting business models to optimise their management of the outputs as the market unfolds.

It is more likely that the present 'federal' structure, which is common amongst those of the major power companies that are pan-European, has established a firm obstacle to the development and realisation of such a strategy.

How do we deliver?

Inherent in the proposition for sustaining foresight is the capacity of the enterprise to pro-actively evolve its structure and operations. This requires an organisation where its people are intimately connected and committed to the achievement of the objective. In its ultimate form, the organisation may even have *executed* with *foresight* before the opportunity for change has been recognised by management. This is how fundamental the challenge might be.

The transatlantic gas and power retailer spent almost five years waiting for the 'IT panacea' to make its foresight real, with an affiliated 'transformation' programme, already two years in development, to realign people and processes with the customer service vision. A five year period during which the consumer moved on, or perhaps five years in which too much focus was placed on a grand vision, rather than achieving significant proof of concept and delivery.

The same organisation is now faced with the challenge of replacing its core resources. Lacking senior or middle management with real relevant experience, and with a Board that has been groomed on branding and retailing, it is not evident that it has either the appetite or capability to effectively pull off this challenge. If it does, it will pay a far higher price than would have been necessary had the same challenge been approached five years ago with reasonable foresight.

The state-owned global power enterprise is now on its second major reorganisation within two years and recently joined the increasing number of European energy enterprises that have replaced their leadership within the past three years. Six months preceding an IPO, it is claiming accolades because all its European operations are now in profit!

'Timing is everything' – and these organisations appear to be already timed-out.

Our independent observer might ask whether there is evidence of any great capacity by European utilities to execute effectively with foresight. In the UK, where utilities have had the longest experience of liberalisation and regulation, few would challenge the assertion that power and gas utilities have lost the initiative to the regulatory forces of Ofgem, energywatch and an assortment of government departments.

One could not have argued with incumbent utilities in the early days of liberalisation and reform that seeking to slow down the process and effectiveness of change enforced externally by government and regulators was in their best interests. The experience, however, is that government and regulators do eventually drive change, while utilities remain disabled in their inability to pro-actively engage in shaping their future.

The power and gas utilities in our examples have not yet faced the levels of challenge that a fully-competitive market can throw their way. Actions to build a new 'business model', like the retail multi-utility, would never have seen light of day, in most cases, if utilities had challenged themselves to understand the real fundamentals of their customer relationship and brand. Acts like the re-creation of the vertically integrated utility would be recognised for the risk reduction and anti-competitive refuge that it really is.

Where do we go from here?

It is my proposition that energy utilities have not yet really started to apply themselves to the shaping of 'winning' business models. At best, what we have seen have been some expressions of ambition that were built on sand and some reactions to market threats that have served only to sustain – so far. We have yet to see a business model that truly creates value.

The industry cannot plan on the assumption that the current, relatively benevolent, environment can be sustained. Shareholder activism in France and Belgium is already a sign that this stakeholder is not happy. The EU's tolerance of vertical integration and cross-border acquisitions is already receding as they flex their new-found 'anti-trust' muscles. The consumer/voter is also showing intolerance having seen that in a competitive energy marketplace prices can actually increase as well as decrease.

It is difficult for any energy utility to quantify the scale of these threats. It is more worrying, however, that none appears to be driving towards being able to step through the challenge. Is this not the type of capability that shareholders should be challenging managers to demonstrate?

Energy utilities need to start now in their search for an honest and deep understanding of themselves and their market environment, out of which a business model can be mobilised to embrace change.

This is 'hard learning' and is uncharted territory for most organisations. You cannot 'benchmark' your way to purpose, foresight and execution. An enterprise has a greater, not lesser, challenge to learn than an individual. However, just like the individual it needs to defeat the two great natural enemies in the pursuit of 'self-knowledge':

i. Fear – the fear of truly confronting the realities of the organisation's current state or position, the fear of future uncertainty, or indeed the fear of daring to take a different position and direction to its peers.

ii. Clarity – initially a strength but a weakness when overdone, causing the organisation to believe it is beyond doubt, and creating the illusion that it can achieve anything it pleases because it sees clearly into everything.

Above all, the organisation that has true self-knowledge is modest and humble in the face of its success. It understands fully the impermanent nature of its success and recognises that its only value lies in the next test of its capacity to evolve with foresight.