

Speaking notes for a presentation by Chris Sheard at the 2003 CAMPUT Conference.

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The subjects of affiliate transactions and affiliate codes of conduct have been much discussed in regulatory hearings, trade literature and at conferences such as this over the last few years. I'm not sure I can add much to this body of work. However, perhaps I can reframe some aspects of this issue and place it in a light that you may not have previously considered.

Now, I do not consider myself to be overly religious, but from observation I can tell that there are a number of parties, many of them in this room, who could benefit from a good blessing. And without saying that the regulated utilities are the first in line, let me discuss them first, by proposing the following beatitude.

Blessed are the utilities, for they have been forced to create affiliates.

To say that utilities have been *forced* to create affiliates may not jive with the common perception that utilities have gone down this path all on their own. No one held a gun to their heads. But in my view, a significant amount of external coercion has taken place.

I believe that ten years ago, the average utility manager would have had a strong predisposition toward keeping all existing utility functions under his or her control. They would not have woken up in the morning with an urge to shrink the utility. They would not have said, "Today I am going to move our back office functions into an affiliate".

So what changed? In my opinion, utility management was *forced* to change their views about what functions should be done within a regulated utility and what functions should be moved to an affiliate. That forcing came from a number of different directions, notably governments, shareholders, customers and regulators.

Recall the period of the early 1990's. The structure of the utility industry was under the public microscope. Many utilities were seen, correctly or not, as inefficient, overstaffed and wasteful. "Rates are too high; service levels are too low" were common complaints.

Traditional rate base/rate of return regulation was seen as a contributor to utility inefficiency because it provided rewards to shareholders for increasing investment in rate base. Many thought that the reward should be for the opposite, that is to say, finding ways to decrease rate base. The pressure coming at utility management from representatives of ratepayers was that "Increasing rate base is bad, decreasing rate base is good".

It was in response to this negative perception of utilities and traditional regulatory methods that governments, with the help of regulators, began planning to introduce competition into the utility marketplace. They thought that competition would produce

lower prices and better service. Without having solid experience to tell them that this was in fact the case, they attached themselves to the ideology that says “competition is good”.

At the same time that customers were saying “decreasing rate base is good” and governments were saying, “competition is good”, utility shareholders were also in the mood for change. They had seen the companies they invested in reach maturity and near saturation of their available markets. After nearly a century of growth as the reach of gas and electricity systems expanded to include almost all populated areas of the continent, the prospect of continued future growth diminished.

Shareholders needed their utilities to find new ways to grow. If growth is not going to come from geographic expansion and continued penetration of the market, then it needs to come from somewhere else. What property or skills were held by the utilities that could be redirected into an opportunity for earnings growth? To a shareholder, earnings growth is good.

So think again of the utility manager waking up in the early 1990’s quite happy with an organization that has all of its necessary components contained under one corporate roof. By nightfall, this utility manager has had irate customers telling him that rates are too high and service too poor. He has been told that increasing utility rate base is not acceptable, and that he should find ways to decrease rate base. Government has told him that a competitive model is coming. And, to round out this fine day he is having, his shareholders have told him that he must find new ways to grow the company or else either he or they are leaving.

Is the utility manager being forced? I think so.

The next morning, the utility manager wakes with the knowledge that he has a plan that can bring happiness to customers, government and shareholders. By removing from the utility a significant asset or function, he can reduce rate base. Furthermore, by placing this function into a competitive market, costs should go down and service levels rise. Both customers and government should be happy. And there is an added bonus. Shareholders will love this plan because it has the potential to cause earnings growth. An asset that previously earned a utility return and provided service only to utility customers will now be able to offer service to an entire new market with the attached opportunity for non-utility earnings. He’d rather keep the status quo, but this plan might just work.

Blessed are the utilities, for they have been forced to create affiliates.

But what of the customers? Do they not also deserve a blessing?

Blessed are the customers, for they have not received what they have wanted.

My thesis is that customers know what they want, but are feeling frustrated that they have not been able to achieve it.

Their wants are basically simple things. They want the lights to come on. They want the furnace to keep them warm. They want to be charged a fair rate. They want a real person to answer the phone. Give them these things, and they will be happy.

But are they happy? I submit they are not. And I think their unhappiness comes from the fact that despite all the changes in the utility world lately, and despite the fact that many of the things customers wished for have been granted, they still don't feel like they are valued as customers the way other industries value their customers.

Did my telephone wait decrease when you outsourced your call centre to an affiliate?

Did billing errors decrease when you outsourced your back office functions to an affiliate?

Did service interruptions decrease when you outsourced your line maintenance to an affiliate?

Did my rates go down when you outsourced any of these functions to an affiliate?

When customers ask these questions, and answer "No" to them all, they are forced to conclude that they are no better off today than they were when the utility kept all these functions in-house. Only they are really worse off, because they have less control over affiliates through the regulatory process than they had over the integrated utility.

Years of working for benefits to customers from affiliate transactions, and precious little to show for it.

I would suggest that the reason why customers have not yet been significant beneficiaries of outsourcing to affiliates is that we need a longer time frame than we have had in which to measure benefits. The cost to the utility of producing a bill or answering calls at the call centre will vary less with the ownership and management structure and more with the economies of scale that come from volume. It is only when these affiliates have been successful at increasing transaction volume, by acquiring third party clients, that customers might expect to see a noticeable reduction in cost. Most utility affiliates have not yet had this degree of success.

Blessed are the customers, for they have not received what they have wanted.

And finally, I should comment on the regulators.

Blessed are the regulators, for they have long-term vision and wisdom.

At least, we hope they do.

In my view, successful regulation of affiliate transactions will come down to this:

Have the vision to recognize that utility affiliates can be beneficial to both utility customers and shareholders.

Have the patience to protect customers from suffering harm in the short term, even if they receive no benefit.

Have the bravery to regulate based on broad values and principles, not detailed prohibitions.

Have the wisdom to recognize that to judge the success of structural change requires a long-term perspective.

Blessed are the regulators, for they have long-term vision and wisdom.

Thank you for your attention.

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