

It's Time to Manage Assets for Growth

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Risking Growth in a Risky World

Asset management and risk management are hot topics. But instead of being used to guide and guard growth strategies, these tools are used mainly for cost management and risk avoidance. For many, risk management has come to mean: “Just say no!” Trying to abstain from risk is not the answer. Despite the temptation to lock the doors and stay inside, a rising economy and market will increasingly put pressure on utilities to deliver growth. If integrated and applied creatively the tools of asset and risk management can support growth strategies.

Many utilities have been burned by the disappointing results of unregulated HVAC and ESCo subsidiaries, foreign adventures, over-built merchant plant capacity and, of course, the energy trading debacle. As a result many companies have announced plans to “return to the core business” and to “squeeze the assets harder.” Some companies are trying to “re-rate base” previously liberated power plants. To avoid future firestorms and asset fire sales many companies are creating “enterprise risk management” groups to identify and manage risks throughout the corporation.

The real lesson from recent strategic misfires is that growth will come from taking existing assets and strengths to new heights. How many of those unsuccessful strategies really built on core assets or competencies? Building on “core” assets doesn't have to mean doing the same old things to or with those assets. There are tremendous opportunities to build asset value by applying new technologies, new business models and new skills to fundamental utility assets. Seizing these opportunities entails some risks - not trying entails even more. No one gets up in the morning excited about working for a no-risk “bare bones pipes and wires company.”

What we call “integrated asset value and risk analysis” searches for asset growth opportunities and the risks associated with pursuing them. It builds on the fact that a firm's value is the sum of the values of all its assets – hard physical and financial assets as well as soft assets such as customer equity, regulatory capital and intellectual resources.

¹ My colleagues Harlan Dellsy, Mark Gerber, Randy Kreuz and Tom Madden made major contributions to the concepts in this paper and reviewed the material.

Nothing Ventured, Nothing Gained

In most cases, utilities were guilty more of over-valuing assets than under-estimating risks. Simply put, too much was paid for HVAC companies, too much was invested in ESCos, foreign utilities were overvalued and the continued growth in trading profits was vastly oversold. There are many ways to overvalue assets; aggressively optimistic growth forecasts, naïve assumptions of synergy, unwarranted belief in the acquirer's superior management know-how and systems, adrenalin (or testosterone) induced bidding fever, unrealistic discount rates, etc. Together these factors swamp any deficiencies in traditional risk management in explaining strategic failures.

When risks are a major factor in undoing a company strategy it is often the “soft” risks such as regulatory risk, human capital risk, management process failure risk, etc. Many foreign acquisition failures resulted from regulatory and political risks, not physical or financial risks. In some cases, most notably energy trading, fraud and misrepresentation played a part. But even here the implied asset values of energy traders and energy contracts should have (and in a few rare cases did) set off alarms. Indeed Enron, the most egregious manipulator, was trying to sustain its unsustainable asset valuations. When the crunch came, all the VAR calculations and all the counter-party assessments didn't do much. The failure of VAR and related risk management tools to mitigate the risk that mattered most, demonstrates that once the bad guys know what you watch, that's what they manipulate.

The social risks demonstrated on August 14, 2003 are likely to create new risk bearing and sharing rules affecting the value of transmission assets. Already some states such as Ohio have moved to mandate that utilities upgrade the “worst” performing delivery facilities – not necessarily those with the greatest upgrade value. FERC is leaning toward an active role in reliability assessment and planning. If past experience holds, utilities will wind up being the risk-holder-of-last-resort while simultaneously being denied compensation for bearing all or part of that risk.

Risk sharing rules influence not only the value of current assets but where companies look for new value. Following the "imprudence" disallowances of the late 80's many utilities were advised to transfer generation cost risks to customers. Wall Street seers favored power purchases over plant ownership as a way of limiting regulatory risk. Some utilities hoped to collect secure but unregulated returns by transferring their generation assets to merchant subsidiaries and buying power from them. The upshot? To avoid “self-dealing,” regulators and legislators (often at the behest of Enron and cronies) froze many utilities out of unregulated opportunities that could have utilized their assets and competencies. Why customers should be denied access to the risk management value embodied in a local utility brand in order to give Enron and a gaggle of under-funded start-ups a “level playing field” has never been entirely clear. Then, when customers felt the impact of market risks, regulators often found ways to transfer those risks back onto regulated entities anyway. The inability of most PUCs to develop rules accommodating

utilities and new entrants prompted some utilities to seek asset growth in more dangerous locales.

Taking Considered Risks is Necessary to Grow

A utility CEO recently interrupted us in mid-presentation and asked “Is this just another approach to telling me what not to do? Can’t you find some things to do for a change?” This CEO understood that executives get paid to take appropriate risks in pursuit of increased shareholder value. To do this they need simultaneously to search for opportunities while unearthing the risks those opportunities entail. Then management can judge if the “game is not worth the candle” or the risk of being burned.

The risks of not taking risks, of simply hunkering down and “squeezing the assets harder,” are missed opportunity and dissipation as illustrated in the table below.

<i>Risks of Not Taking Risks</i>	<i>Opportunities Involving Risk</i>
Sacrificed opportunities	Taking advantage of new technologies and market needs to create new value
Vulnerability to innovative, aggressive competitors	Leveraging natural advantages to become innovative, aggressive competitors
Potential takeover by growth oriented acquirer	Creating a superior, scalable and transferable acquisition business model
Dissipation of intellectual capital and know-how	Addressing the growing know-how deficit
Regulators begin to question premiums and compensation	Correcting the flaws of first stage restructuring

Risk avoidance can go too far. Installing new risk management groups may itself prove risky. They will certainly find risks and they will certainly find ways to avoid them. But risk is only a component of a larger picture – asset value. Looking at one and not the other is risky. Opportunities can be missed and corporate atrophy will set in at a timid enterprise.

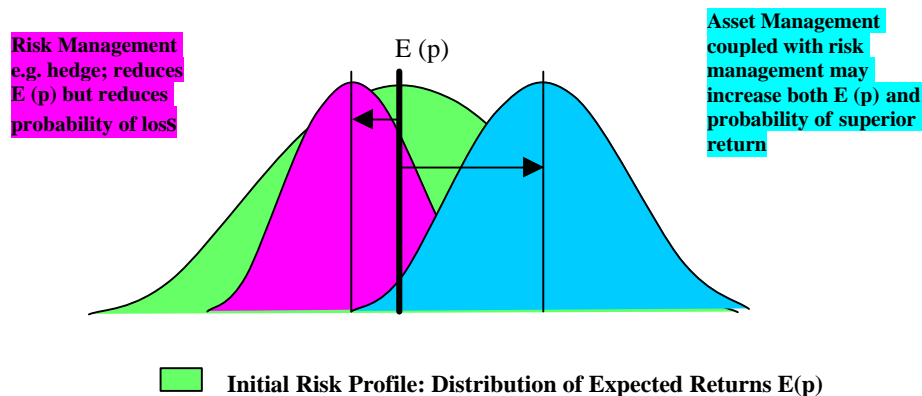
Principles of Integrated Asset Value and Risk Analysis

Integrated asset value and risk analysis is a structured method of searching for ways to grow shareholder value by analyzing the firm’s assets, identifying ways of growing those assets’ contribution to corporate value while managing the associated risks. The following principles and observations underlie the concept and its application.

- The firm’s objective is to increase the asset (tangible and intangible) value of the firm – not to avoid risks.
- Firms increase their value by taking calculated risks.
- The firm’s appropriate level of risk-taking is defined by investors and is reflected in the cost-of-capital to the firm.
- The value of a firm is the aggregate value of all of its assets – not just those measured by accountants and not necessarily as measured by accountants.
- Many of the most important but “soft” assets such as customer equity, human capital and vendor relationships are usually not measured or managed as assets.
- In this information age, soft assets and their risks usually determine the success of efforts to increase hard or financial asset values.
- An asset’s potential values can be estimated as a probability distribution defined by its expected value and the variance around that value which reflects risk and uncertainty.
- An asset’s expected value is a function of the expected value of underlying variables. For example, customer equity is a function of customer purchase rate, retention rate or tenure, acquisition cost and margin on purchases.
- The variance of an asset’s expected value is a combination of the variances of the underlying value-driving factors. For example, the variance of expected power plant value reflects the variances around expected future electricity prices, fuel and other input prices, plant availability and load levels.

These dry-sounding principles underlie a very powerful way of growing value. In short, asset management seeks to move the expected return on an asset $E(p)$ below] to the right while risk management tries to trim the potential for bad outcomes (illustrated by the tighter distribution of expected returns).

Integrated Asset and Risk Management



The key to discovering opportunities and managing risks is “de-averaging” – understanding that all plants, circuits, customer relationships or any other assets are not

created equal. Each plant, each circuit, each customer relationship has a unique distribution of potential value that reflects its history, its make-up and the factors that drive that value. The “right” level of unit availability, outage frequency, or customer service is that which maximizes asset value subject to the risk of achieving that value. The risks faced in achieving those values come from the fact that little is certain in this world; fuel costs change, demand varies, customer preferences change and, most uncertainly of all, some new guy may come along and change the rules

Creating an Asset Value and Risk Profile

Wouldn't it be great to have a profile of all your major assets indicating which ones were under-developed, what risks they were subject to, and the most promising strategies for realizing their value while managing that risk? Fortunately, there is a 3-step process for recovering from risk phobia.

- Conduct an asset value and risk management diagnostic
- Model your asset value(s) and risk profiles
- Adopt an asset and risk management perspective

Conduct an Asset and Risk Management Diagnostic

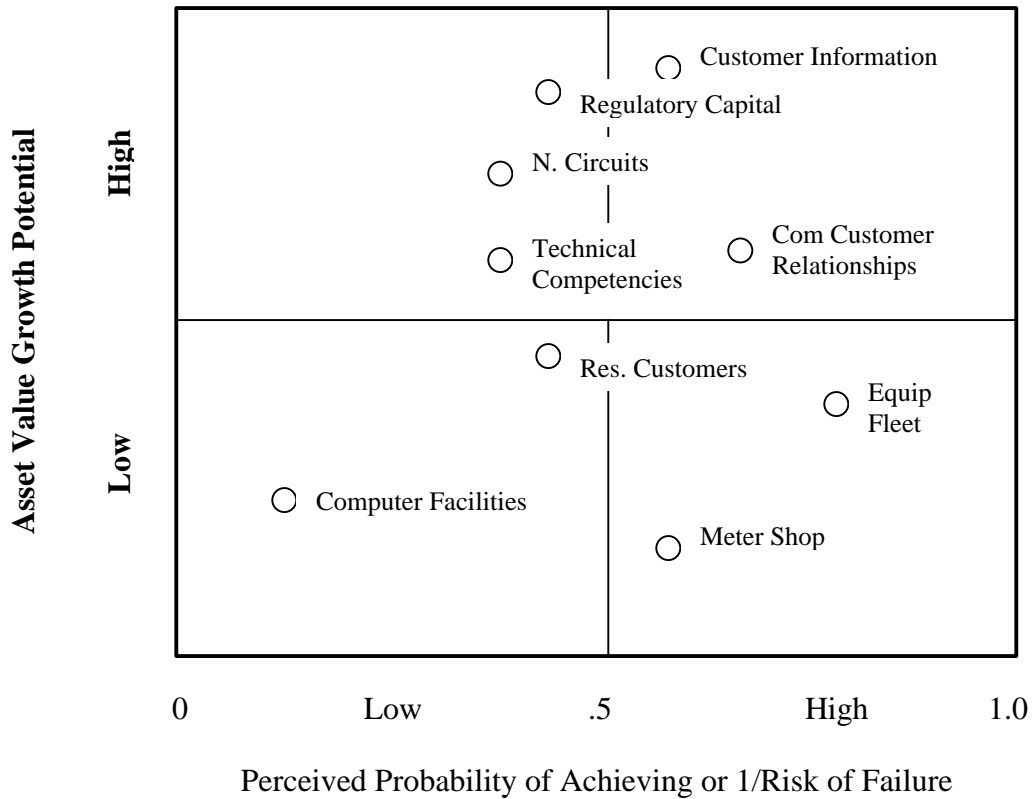
The first diagnostic task is to catalogue your assets. The big tangible ones are relatively easy- wires, transformers, etc. But soft assets such as customer equity, brand, regulatory capital, etc. are more difficult to evaluate. We've developed diagnostic tools for major utility asset classes that help you answer the questions:

- Do we fully understand our underlying asset value and risk structure?
- What's this asset class really worth, what would someone pay for it, why?
- What's it worth to do better or worse?
- What are the potential ways of growing the value?
- Are there alternative business models to create and capture value?
- Are there analogies to other businesses that might help us imagine new models?
- What sort of regulatory or institutional barriers are there to realizing the potential value and mitigating risks?
- What could go wrong?
- What risk hedge, insurance, avoidance and mitigation options are there?

Once you've got a handle on your assets, the next step is to begin ballparking the potential for asset value growth and the perceived risks of achieving that growth. Here it is often useful to take different perspectives and view assets afresh. When you see a circuit or a feeder do you see a cost generating facility or a potential revenue producer? Is it merely a delivery mechanism or is it a “store on poles?” Do you see people along that line who ache for an uncluttered view, higher reliability, period lighting – and are willing to pay for it? These are some of the questions that underlie my colleague Randy

Kreus' notion of "differentiated delivery" a form of asset and risk management for delivery assets.

Preliminary Diagnosis of Asset Value and Risk Potential



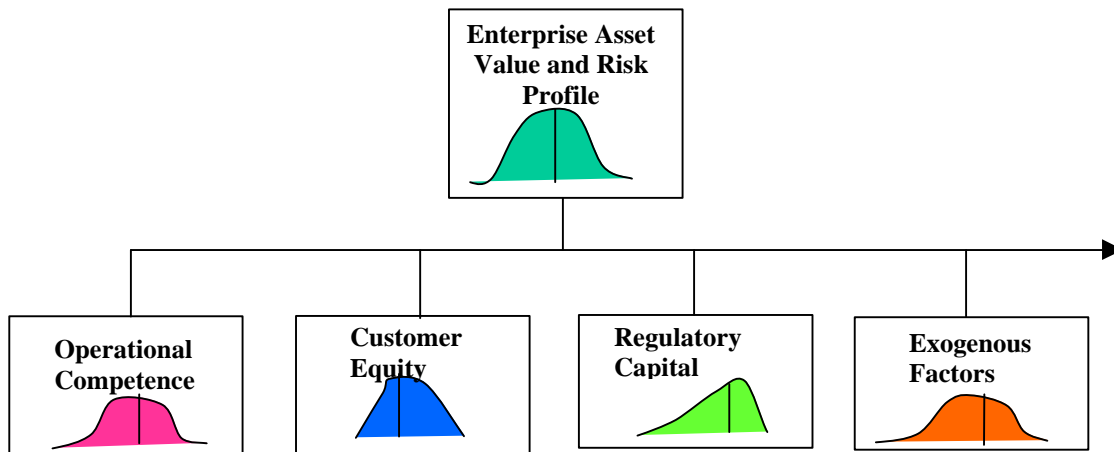
The outcome of an asset value and risk diagnostic is a profile of growth potential and the likelihood of achieving that potential as seen by the organization. It can also stimulate discussions of how to capture value and/or mitigate risks. For example, some assets may call for a new business model (e.g. customer information), some can be offset by derivatives or hedges (e.g. contracts), some are candidates for risk-shifting to outsourcer (e.g. computer facilities), etc.

The preliminary asset and risk map is simply a starting place. It helps to organize the available data and to highlight areas of consensus or divergence thus setting the stage for more rigorous research and analysis. In some cases the evidence on "low hanging fruit" will be compelling and those opportunities should be pursued immediately. In other cases, the investment in analysis can be calibrated with respect to expected pay-off.

Model Your Asset Value and Risk Drivers

Tremendous progress has been made in developing asset valuation and risk models for generating units (e.g. MIDAS Gold Analyst[®]) that enable planners to create probabilistic profiles under a wide range of potential future states. But very few companies have a comparable ability to model the value of their delivery assets, regulatory capital, customer relationships, etc. The modeling of these assets is, in principle, similar to that employed in generation. A structural model links asset value and risk drivers, enabling you to simulate the outcomes of growth strategies and to assess the related risks. Initially there may be some misgivings over the quality of data informing estimates of future states and risks. For example, hard-to-estimate failure rates, customer defection rates, political shifts and other factors may have important consequences for tactics. But, it is better to deal with uncertainty by explicitly modeling it than to defer analysis until perfect data is available.

As illustrated below, the company's potential asset value is the aggregate of the potential values and risks of its constituent assets.



Adopt an Asset and Risk Management Perspective

To realize fully the benefits of integrated asset and risk management, a company needs to address corporate perspective, process and organization. Consider the change in generation asset management. In the old, cost-plus regulatory world generation managers sought to maximize unit availability and minimize heat rate. Utilities scoffed at the way the new IPP and co-generation plants were designed, built and operated. The new guys treated each plant as an asset with it's own P&L and they achieved better-than-respectable performance and returns by standardizing designs, leveraging technical skills and focusing on maximizing asset value. They pushed ideas such as "tolling" and offered a whole new range of power purchase contract options. While recent events suggest that some of them didn't manage risks as well as they thought, utility and affiliated generators have largely adopted the IPP business model.

- **Corporate Perspective.** Sarbanes-Oxley makes every director a risk-manager but it may also make her or him an aggressive risk-avoider. The CEO has to certify the accuracy of past performance to shareholders but more importantly he or she needs to find a way to present potential growth and associated risks in a way that board members can understand and feel comfortable with. A comprehensive corporate asset value and risk profile can help to balance the board's perspective and give them ammunition to ask what's being done to grow shareholder value as well as to protect it.
- **Systems and Processes.** Integrated asset and risk management is very different from traditional budgeting and planning. Although many of the things done look similar there is a world of difference between optimizing the value of customer equity and meeting mandated customer service standards. There is also a big difference between optimizing the value of your regulatory relations asset and complying with regulations. Incentive systems that reward managers for riding the bull should be reconsidered in light of the ability to estimate real asset value changes and compare those to the general level and movement of the market or among peer companies.
- **Organization.** Asset management in generation took off when companies adopted fleet or unit P&Ls that targeted profitability. Before then, heads of functions such as maintenance, operation, fuels management, etc. were only loosely coordinated and tended to optimize within their sphere. Similar fragmentation of responsibility in the delivery, marketing, customer service and other areas makes it more difficult to focus on asset value. Imagine the difference in behavior that assigning profitability for circuits – the store on poles concept – would stimulate.

Conclusion

It's understandable that utilities would become cautious after their experiences with a host of disappointing growth strategies. But the pendulum may be swinging too far in the other direction, threatening the unintended consequences of stagnation and decline.

The market has changed, the role of utilities in that market has changed, and they will change even more. There are tremendous opportunities to create the utility of the future on the foundation of today's assets. It will take some courage to risk to grow. It will even take risk management to keep everyone sober and focused. But don't put the brakes on before the vehicle is moving.