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PREPARING UTILITIES FOR DEREGULATION IN THE PRE-SMD ENVIRONMENT

*World Energy interviews Mark Fronmuller,
Americas Utilities Leader, Cap Gemini Ernst & Young*

World Energy: We've had some time now to watch utility deregulation in various states. Is the process beginning to gel, or at least exhibit some key trends?

Fronmuller: The California electricity price runup in 2000 finally focused the public's attention on the name of the game – ensuring the availability of generation and transmission capacity. In the short term, we see this issue being paramount, particularly in light of the fact that the Federal Energy Regulatory Commission has responded to it with the Standard Market Design initiative.

The big question is timing. The development work on SMD – by industry, regulators and NGOs – will take years. If current projections of a 2006 conclusion are correct, the coming three years are going to be very interesting.

World Energy: What do you foresee?

Fronmuller: For one thing, the current proposal is likely to create several large-scale industry changes. This means companies need to look forward and invest in technology now, while the process is underway. With the war in the Middle East now and the Congress back in session this spring, it is hard to tell how the near term will play out, but we are confident that major systemic changes are just around the corner.

World Energy: Isn't that a little risky, like starting the build-out before the blueprints are done?

Fronmuller: We don't think so. Companies should do things like redeploying stranded IT assets. At many companies there is excess server capacity that's been left in the wake of diminishing trading operations. Companies can also reevaluate their IT outsourcing, especially labor sources, from top to bottom. There are bargains galore these days for software and hardware.

World Energy: In addition to technology, what other business issues will be critical?

Fronmuller: Companies will likely find it prudent to get back to the basics of blocking and tackling in their business practices. In addition to focusing on core competencies, companies should plan on making strategic management decisions like transformation outsourcing or other means to cut costs on those activities that are extraneous to their core business.

For example, a generating company that is great at creating electricity should hone that ability, but think twice about a large investment to learn retail customer service. At this point, gaining new competencies may best be accomplished by good strategic partnering and outsourcing.

World Energy: Are there any other new approaches to business issues of note?

Fronmuller: Companies should operate "as if" they are operating in a competitive, deregulated environment by streamlining costs and managing assets better. Management concepts like adaptive supply chains and asset optimization work to accomplish those goals. Also, now is a great time to evaluate, grade, and examine operations like quality of service and cost effectiveness. Using this "quiet time" to determine exactly how a company measures up against key corporate performance benchmarks will show management the gaps that need to be closed.





World Energy: The lack of investor confidence has impacted every publicly held company's ability to raise capital. What are your views?

Fronmuller: There's no doubt tomorrow's energy businesses will look very different because of the need for greater accountability. Stronger risk controls, procedures and information systems will go a long way toward restoring the investing public's faith in the numbers companies report. It will also increase customers' faith that they are paying a fair price for a reliable product.

World Energy: The transparency issue notwithstanding, hasn't deregulation created an environment of investor uncertainty specifically for the utility industry?

Fronmuller: Absolutely. In fact, Cap Gemini Ernst & Young just completed its second annual utility industry survey. It found that most executives at global utility companies warn that deregulated markets cannot afford to wait until SMD is implemented to reward the capacity and connectivity investments that need to be made now.

World Energy: So what management practices should companies employ to encourage new investments in utility infrastructure?

Fronmuller: The mega-generators have done a fairly good job of using information technology to gather information across their generating portfolios. They've created excellent information dashboards for optimizing the asset operations in this environment. However, there is room for improvement in the decision-making around optimizing asset economics based on that information. This is especially true for the trades executed against those assets.

There is a new set of questions and constraints for using data to run an organization. Optimizing assets in this new environment is a mathematically intensive process. The mathematical process helps determine the best possible combination of transactions – in spot and forward markets. This approach can yield the highest expected return across an entire organization while honoring the new set of constraints in which the utility operates.

World Energy: How should the best practice recommendations of the Committee of Chief Risk Officers fit into companies' enterprise risk management strategies?

Fronmuller: The CCRO has stepped forward at a critical time and provided a crucial leadership sounding board for industry practices. Ultimately, risk management practices are particular to each company, their tolerances and generating and transmission capabilities. Risk management controls and standards should not be a reaction to the industry's current predicament; rather, they should be part of a commitment to its employees, shareholders and customers that a company understands the nature of being an "adaptive enterprise" and what that entails now and in the future.

World Energy: What can companies do to address the 3 C's: credit, clearing and confidence in today's power markets?

Fronmuller: The industry has to come to an agreement on these issues, something that is easier said than done. The good news is that organizations are stepping forward to assist the industry do just this. The Global Energy Management Institute at the University of Houston has facilitated two excellent forums this year on precisely these issues. It's reassuring to see representatives from fiercely competitive companies come together to air their positions on these issues. That's been a great first step.

The jury is still out on the regulatory response to each of these three related issues, but regardless of the signals from Washington and the state public utilities commissions, the industry needs to do a better job of educating the public (investor and consumers at large) on why energy markets matter and how the industry has learned from its mistakes in the recent past.

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