

UTILITIES SECTOR

Deregulation  
Sparks  
Transformational  
Sourcing Among  
Utilities

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## INTRODUCTION



**The ongoing competitive pressure spurred by utilities deregulation has now freed - or perhaps forced - utility executives to consider alternative sourcing strategies as an integral factor in positioning their companies for strategic advantage.**

Utilities have considered the advantages of outsourcing for years, though it usually involved transferring people rather than assets in the regulated era. The ongoing competitive pressure spurred by utilities deregulation has now freed — or perhaps forced — utility executives to consider alternative sourcing strategies as an integral factor in positioning their companies for strategic advantage.

More than ever, the focus for utilities is on cost reduction, variability of costs and better service provision to stay in business and sustain success, thus executives are getting more serious about investigating new alternatives for competing more effectively. Based on the regulatory history and resulting industry participant behavior that ISG has noted in this sector, we believe that utilities' appetite for sourcing alternatives will continue to grow.



## BACKGROUND AND EVOLUTION OF THE UTILITIES INDUSTRY COMPETITIVE LANDSCAPE

The deregulation of some electric power markets has ushered in an era of new competition among the utilities in North America, and competition is forcing power providers to offer consumers more competitive rates with variable cost structures versus the traditional fixed cost structure.

Today, asset transfers and third-party sourcing are becoming more attractive, allowing utilities to sell their non-core business - and Information technology (IT) related operations and associated equipment to their chosen service providers. In this way, they may lower their overhead costs and sell electric power at a more competitive price for the consumer while maintaining profits.

In the past, some utilities and service providers formed joint ventures in order to launch and evolve customized, commercial capabilities. Joint ventures such as Capgemini Energy, which is co-owned by TXU (Texas-based utility), meant that both entities could attract newer and greater numbers of customers while simultaneously allowing the utility to gain a share of the proceeds. In response to this model, a large number of IT service providers have strengthened their specialist utility areas and can also boast a critical mass of utility customers in a fairly specialized market.

With TXU having adopted a successful outsourcing strategy in 2004 that contributed to the quadrupling of its stock value, other utilities are now eyeing similar options as a sound bet for their long-term future. Some of the largest industry players are now vigorously considering outsourcing business processes and IT components to gain an edge or to simply stay in the competitive game.



**Utilities executives do not want the service provider to "run the same mess for less"**

## RADICAL TRANSFORMATION IS IMPERATIVE FOR MEETING DEREGULATION CHALLENGES

Utilities' transformation goals revolve around a quantum shift in capability rather than merely making over the back office of IT, Finance & Accounting, Human Resources, Customer Relationship Management (CRM), Procurement and other functions. Today's utilities executives do not want the service provider to "run the same mess for less." Instead, they want the service provider to help them radically transform the services they are currently supporting. This means fundamentally transforming and boosting productivity and efficiency, which leads to cost reductions and better performance that positions the utilities for a deregulated (or — at minimum — less regulated), more competitive environment.

Utilities continue to experiment with outsourcing contract lengths, number of service providers and scope of services delivered. Many believe that they may negotiate lower costs if they outsource entire functions — or end-to-end processes such as procure-to-pay or

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hire-to-retire — for longer terms. Other sourcing transactions have a narrower scope, such as outsourcing Applications Development & Maintenance (ADM) to a firm that can do it more efficiently with a better cost structure.

Because utilities want and need to improve the way they do business, they desire best-of-breed technologies and world-class processes that service providers can offer. Accenture and Capgemini, with strong transformational consulting experience, are strong service providers in this scenario. Others such as EDS and IBM have quite large utility customer bases, albeit primarily in the IT realm.

ISG expects to see more outsourcing transactions in the utility industry this year and in coming years. After the TXU outsourcing transaction in 2004, our company saw its pipeline for transactions in the energy sector grow as utility firms adopted assessments of alternative sourcing options at an unforeseen pace. TXU's four-fold rise in stock price has certainly spurred its peers to look at sourcing as a viable approach to transforming their businesses to meet the changing demands of today's more competitive climate.



**Utility companies must stay in touch with their local consumers. For this reason, CRM has always been a formidable requirement and challenge for utilities.**

### **SOURCING OPTIONS CAN HELP ADDRESS ONGOING CUSTOMER RELATIONSHIP MANAGEMENT CHALLENGES**

Utilities are still viewed as a community service, and utility companies must stay in touch with their local consumers. For this reason, CRM has always been a formidable requirement and a challenge for utilities. Owing to the enormous number of residential customers that must be served, the demand for more sophisticated and unique systems to enhance customer-facing business processes runs high. Often, in fact, a utility's entire employee base has annual bonuses linked to customer satisfaction statistics, so they are very focused on customer service interaction and satisfaction. Some are outsourcing both people and technology. Others outsource only the technology, electing to keep their own people so as to remain closer to the local community and to regulators.

### **SMOOTHER MERGERS AND ACQUISITIONS, GREATER COST REDUCTIONS THROUGH TRANSFORMATIONAL SOURCING**

The energy industry expects more utility mergers in the wake of deregulation, which will, in turn, stimulate greater interest in outsourcing strategies.

Merging companies stand to benefit from cost reduction opportunities as they successfully integrate and transform their respective operations into single entities, and outsourcing can help pave the way. Merger and acquisition (M&A) activities, consolidation and other emerging business opportunities are creating substantial demand for transformational sourcing strategies in the utility industry. Cinergy's US\$9.1 billion merger with Duke Energy and Exelon's acquisition of Public Service Enterprise Group (PSEG) are two examples of high-profile M&A activity among utility operations.

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## OUTSOURCING IN UTILITIES INDUSTRY POISED FOR ACCELERATION

As demonstrated by TXU and others, utilities are increasingly recognizing the need to adapt to today's market conditions and are acting on that knowledge. And although they may slightly lag some other industry sectors in their speed to change, ISG believes that, based on current trends, utilities will pursue sourcing strategies more aggressively as they look to remain competitive, reduce costs and increase customer satisfaction.

## ABOUT THE AUTHOR

### **UTILITIES SECTOR**

#### **Deregulation Sparks Transformational Sourcing Among Utilities**

Published January 3, 2013



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Nigel uses his scientific computing knowledge and extensive IT sourcing expertise to help clients in the travel, chemical, life sciences and energy industries navigate today's changing business landscape. Adept at discerning service provider capabilities, he draws on a wealth of knowledge about a wide range of sourcing options. He is intrepid in his go-forward strategy, even with the largest of clients. His vast international experience setting up projects around the world has given him a cultural flexibility that enables this native Brit to thrive in Texas. Nigel earned a doctorate in chemistry from the University of Sheffield in England.



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