EXECUTIVE INSIGHTS

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Electric and Gas Utility "Real Time" Scenario Planning

Electric and gas utility executives have two broad challenges. First, they confront increasing complexity, as their companies adopt new regulatory constructs or merge and span new regulatory jurisdictions. Second, they face pressing external factors, like challenging credit markets, fuel price volatility, and increasing environmental pressures.

These challenges ebb and flow, but they can put strains on an organization. To adapt, the company needs to have the ability to respond rapidly to financial questions that arise from changing business circumstances. Without it, executives may find it difficult to manage financial performance, determine appropriate guidance for equity analysts, and effectively manage credit agencies. In short, these challenges can hinder a company's future strategy and financial planning.

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Does your company have rapid response capabilities to address business questions or sensitivities? It comes down to a simple test. What happens when the chief executive officer, chief financial officer, or other executive asks "What if?" The question could be "What happens to next year's earnings if fuel costs increase 10 percent?" or "What is the effect of deferring a planned generation capacity or gas storage addition for one year?"

In some companies, the answers may take days to determine. This is not because those pursuing the answers are not motivated or capable. Rather, the answer is difficult to ferret out in these organizations because it is embedded within an overly complex planning process that requires input from the broader organization. For these companies, it can be difficult to resolve performance variances quickly. The ability to respond to market changes is weakened. Trust in financial forecasts can break down.

These planning process breakdowns can be frustrating to executives. Sooner or later they may stop asking such "what if" questions, either because they can't wait for the answer or because they don't want to cause the organizational stress required to generate answers. When the demand for information about business scenarios or sensitivities falls, the organization's ability to respond to change or manage performance declines even further.

Symptoms of planning process breakdowns may include:

- Missed earnings guidance or credit metric performance for reasons that could have been anticipated
- An array of planning models that are managed by different organizational units
- Lack of accountability for the integrity of financial forecasts
- Too much focus on high-level financial output with limited ability to see or manage underlying management drivers of financial performance
- Budgets that are inconsistent with even the first year of a long-term plan
- The existence of multiple versions of the current financial plan in different parts of the organization

Rapid Response Planning at NiSource

NiSource Inc. has taken major steps to implement a more responsive and effective planning process. With over three million electric and gas customers across six states, the business was managing reasonable levels of complexity. Business planning efforts were keeping up. But NiSource's CFO, Mike O'Donnell, was sure that they could do better. He targeted three actions to improve planning efficiency and responsiveness.

- **Corporate model upgrading. The model needed to be more driver-based and have the ability to run real-time business scenarios.**
- **Value-driver focus. The company's corporate long-term plans relied too much on financial data without enough focus on underlying performance drivers.**
- **Streamline the planning process. As the business had grown and evolved, planning within certain business units had gained complexity.**

O'Donnell moved forward to make improvements in these areas at the corporate level, and did so in three months. As a result, he believes that the quality of executive planning discussions has significantly improved. "We are able to have much more insightful discussions – not just about the performance of our business, but also about the causes of performance changes."

O'Donnell retired as CFO last year, and his successor, Steve Smith, is pushing the concept down to the NiSource business unit managers who are trying to streamline business unit planning and implement a value-driver-based focus within each unit.

Of course, companies vary widely in their planning capabilities and cultures. Some have dealt with these slow-response problems, while others still experience them to some degree. Regardless of where companies are on the response spectrum, most can make improvements to internal financial and strategic planning capabilities that allow for faster response to volatility and greater mastery of business and market complexities. These changes help executives manage real-time in a world that runs at Internet speed.

The good news is that the solutions do not involve an expensive, complex data management system.

Focus on Key Business Drivers

Many companies rely too much on high-level financials to plan and manage business performance. In doing so, they limit their ability to explain performance shortfalls and reliably forecast business results. The first step toward new scenario planning is to reorient the planning process to focus on underlying drivers of financial performance – the revenue components. Instead of focusing on "revenue growth," for example, the planning process should look at customer growth, energy usage, and so forth.

Most power companies do an admirable job of building up a revenue forecast based on a very detailed and complex forecasting model. However, this detail often resides in a "demand forecasting group" deep within the organization. The drivers don't reach the corporate level. Instead, executives receive high-level revenue results without the accompanying driver detail for, say, customer count by category, or usage data. If these executives want to ask questions about the revenue forecast, they often have to summon the demand forecasting group to explain. This takes time.

This silo approach to planning also can miss key relationships among drivers. A simple example: Increases in fuel costs can drive customer billing increases, which in turn can drive up bad debt and working capital. The scenario may now have to involve a separate "cash-flow forecasting group." As a result, discussions of variances and planning scenarios can quickly span the organization. This takes even more time.

The understanding of "what drives what and by how much" cannot reside entirely in specialized groups. The key planning drivers that explain financial results must constitute a common, corporate-level language to talk more meaningfully about planning performance. To do this, many organizations have gone through the process of mapping all important drivers (*see Figure 1*). Such maps help everyone know how their specific data feeds the whole. The maps help executives speak about variances to investment analysts and credit agencies. They also help financial planners add value to their analyses.

Rapid-Response Planning Model

If those key drivers are the language of planning, everyone should speak it consistently. But while creating the language takes the most effort, making it part of the company's natural speech can be accomplished with an Excel-based financial model that captures appropriate driver detail from business units and groups.

Consider the case of a utility whose company corporate planning capability was disjointed. Scenarios took days to run. Managers in different organizational departments had to "turn the crank" on six different models in order to generate a new scenario (*see Figure 2*). If one manager were on vacation, the process took even more time.

Figure 1

Example of Performance Driver Map

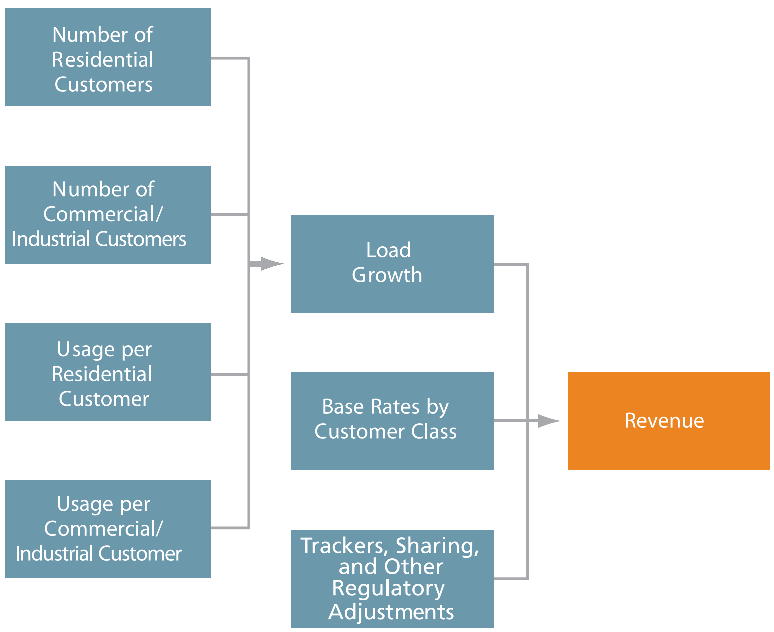
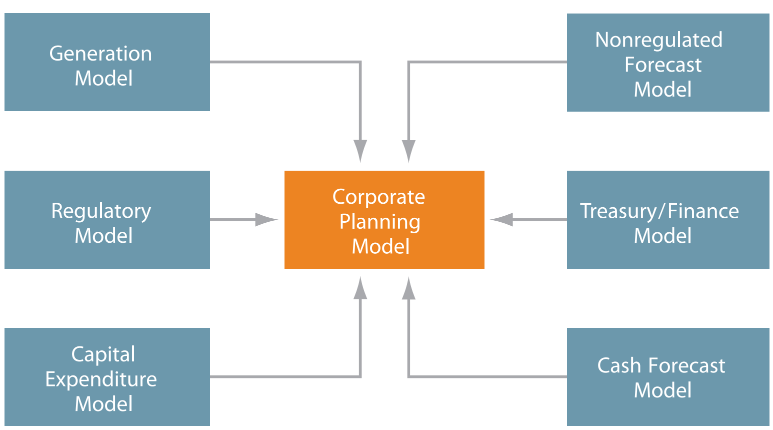


Figure 2

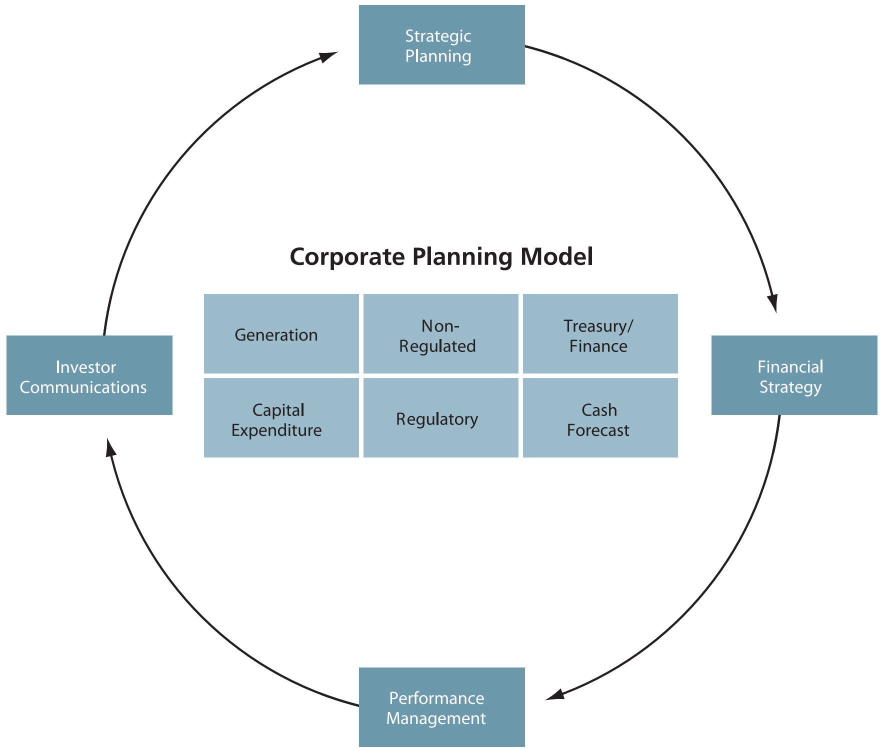
Before Adopting Rapid-Response Planning Model



A new financial planning software model incorporated assumptions, data, and budgets from the entire organization. Instead of six models, one model captured the internal logic of the others. This enabled one person to run scenarios without having to impose on a host of others within the rest of the organization (*see Figure 3*).

Figure 3

After Adopting Rapid-Response Planning Model



Streamlining

Long-term financial planning is a management imperative as a company tries to anticipate regulatory action, plan for capacity additions, and manage credit strategy with a long-term perspective. Focusing on financial drivers and creating a consistent language can increase the "return on effort" for financial planning. But they can lose their effectiveness if everyone talks at once: Some organizations also require improvements to their underlying planning process. For these companies, creating a long-term financial plan is a time-consuming and painfully detailed process. In the worst case, weeks or months of data churning and iteration lead to a plan that ultimately goes to the board of directors but after that starts to lose relevance as business conditions or decisions change. This process can be ritualistic and distracting and leave many managers scratching their heads, saying, "Why do we even do this?"

You may recognize some symptoms of planning inefficiency.

Set-and-forget long-term planning

Developing a long-term financial plan that goes to the board and then sits on a shelf involves an enormous waste of resources – and as time passes, the larger plan becomes less relevant as a basis for scenario planning. It also makes the process of developing the next year's long-term plan equally time consuming.

Useful long-term plans are up-to-date ones. This means revising them with current assumptions at least quarterly, if not monthly. That way, when an executives asks, "What if…," the company does not rely on a forecast that is six months out of date.

Business-unit planning complexity

Business-unit planning approaches vary widely, and some business units suffer from the same burdensome complexities that affect companies overall.

Planning models may be too complicated or disintegrated, and information may reside in organizational silos. This complexity can result in lack of ownership of the plan throughout the organization. A culture where the business managers don't "own" the numbers diminishes the quality of the forecasts and significantly impairs the ability to explain variances to the plan.

One utility business planning system involved 15 different models and databases that had to be coordinated to develop the financial plan. Simplifying this system enabled the business to spend far less time creating a plan, and more time examining scenarios and implications.

Short- and long-term plan mismatch

One clear symptom of planning inefficiency is when the annual budget and the long-term plan do not agree. Ideally, the first year of the long-term plan agrees at all times with the budget, even though the budget by necessity captures far more detail.

How do short- and long-term plans fall out of sync? The usual reason is that after the budget is first approved, a change occurs to the business that requires a change to the budget – and many companies fail to update the long-term plan. So two versions of the "truth" now circulate through the business.

This problem becomes acute as the business progresses through the budget year. Over time, the variance between the plans may increase. This makes the long-term plan increasingly useless as a basis for running scenarios or for setting guidance for the next year.

Streamlining the strategic and financial planning process can be difficult. In many cases, these practices have evolved over a long time. Individuals may view ownership of certain data or models as integral to their job description. Achieving benefits in these areas can mean having some people relinquish control over planning activities that they have owned for years. But the organization can justify the temporary disruptions and changes as it creates a more responsive and efficient planning capability.

Conclusion

Change is a constant, but the pace of change is not. Most organizations would agree that business conditions are changing faster than they can react. And while companies cannot always avoid the forces of change, they can increase their ability to rapidly alter course as change dictates.

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