The Regulated Community: Winds of Change

Remarks of:

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Dr. Arthur Thompson, in a recent Fornightly article stated, "that the winds of change are gathering force in the electric energy market place." 1/

I submit ladies and gentlemen that every facet of the regulated community is in the throes of massive transformation. Of greatest concern to we regultors is the manner in which the various industries are responding to that change. I fear that the response will be to little and too late.

It is widely known that the early history of the energy industry was blessed by declining cost economies. Major economies of scale existed in constructing and operating of utility systems. In the electric industry the average cost per kilowatt-hour sold declined as companies constructed larger generating facilities, improved transmission and distribution networks and operated their electric systems at a near practical capacity. Utility management proposed lower rate structures and declining block rate designs which resulted in customers paying a lower average price per kilowatt-hour of usage.

In the gas industry the 1960s and early 1970s found an environment where the supply exceeded customer demand. The price of natural gas was decreasing and the product was in heavy demand for residential, commercial and industrial users. As additional customer and sales were added, fixed costs were spread across a larger base resulting in natural gas being priced artificially low. This allowed everyone to be happy - customers, management and regulators-alike. Lower costs to the company coupled with lower average revenues per

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1/ Public Utilities Fortnightly, June 21, 1984 at p. 31.

therm and kilowatt-hours sold kept company profits reasonable, while at the same time the growth in customer usage increased steadily. This same period found the communications industry operating as a giant coglomerate with a totally closed market structure. Most states aggregate revenues on a statewide basis and distributed costs pursuant to an artificial allocation formula. Pricing determinations were made based on a "value of service" concept, ratepayers paid for service according to the value of that service to them. Much of the service rendered in the monopoly market was uneconomical and almost everyone agreed that few services, if any, were priced at cost.

The forces at work today are such that otherwise conservative industries must recognize the need for and begin to move in the direction of change. Why? For many reasons. The last decade in the energy area (with its constant and rapid rate increases) has resulted in price and usage sensitive customers. Growth in peak loads and usage began flattening at a pace that exceeded predictions. Long-run price elasticity effects substantially affected usage and load growth. Reserve margins in the electric industry were unexpectedly larger and are expected to remain that way well into the 1990s. The resulting efforts by electric companies to utilize their idle generating capacity has made the market for bulk power and unit power sales highly competitive. Excessive generating reserve margins have made rivals out of companies which, in times of short supply, considered themselves allies. Wholesale buyers, seeing that they are in a position to obtain bulk power from several willing suppliers, have begun to negotiate vigorously. Signalling a willingness to turn

to alternate suppliers. Companies short on low-cost base load generating capacity are being actively courted by capacity-long firms needing off-system sales opportunities. Moreover, there are signs that the price competition so prevalent in the wholesale and bulk power market segments may eventually include larger industrial users. With substantial increases in electric rates, manufacturers have been creative in developing appliances and equipment which perfor effectively while using less energy. And of interest is the growing trend in customer behavior such as conservation efforts, (e.g. weatherization), the installation of alternative heating sources, (e.g. fireplaces, woodstoves, kerosene heaters) and the increased use of products that foster energy savings (e.g. light bulbs, heat pumps) which all impact on the electric industry as a whole.

In the natural gas industry, customers are beginning to use alternative fuels, gas producers are seeking direct sales into attractive markets, and pipelines are beginning to compete with one another. The 1983 advertising campaign of the gas industry was specifically geared toward obtaining a larger market share of the elec residential space and water heating customers. And it should not surprise anyone, that the gas distributors are now, actively, courting the volume users, the commercial and industrial classes. It is also important that we acknowledge and understand that a great portion of energy users (be they residential, commercial or industrial), are, to the most degree, indifferent as to whether their energy source is

electric or natural gas or, for that matter, anything else. Although local telephone companies are somewhat assured a continued lion's share of the local exchange market, divestiture, and the resulting threat of by-pass is a reality that must be adequately addressed. Thus far, the bypassing has occurred on a small scale relative to total BOC traffic. But technologicial progress continues, the new emphasis on competition in the philosophy of telecommunication regulation encourages the expansion of the new technologies, and as they expand, their costs will come down. The long run potential clearly exists for the capture of a substantial portion of local telephone company traffic; and the resulting increased costs to the remaining telephone customers. The only relevant factors in the 1980s will be cost. The more choices that emerge, the greater dependability of those choices, the greater the price disparity, - the greater the competition to the regulated utilities.

The "winds of change,"I submit, most emphatically are gathering force.

The period of stable, robust growth, that regulated utilities enjoyed for the quarter century after World War II have ended, aparently, forever. The shocks of the oil disruptions, the effects of the recent recession,the divestitureof AT&T, and deregulation of natural gas, have fundamentally altered the basic fibre of these industries. These industries will never return to that period of its history that we could fondly describe as "the good old days."

And those members of the electric industry who are still predicting that sales growth will return to levels approximating 3% to 4% as a direct correlation to economic recovery, are embracing hopes and not reality. Those members of the gas industry who feel they will soon be able to return to selling product at prices significantly below that of their competition are failing to face the realities of a Congress that has yet to develop an energy policy for its nation. And those of you here, today, from the telephone industry that feel all of your problems could be solved, effectively by pricing local telephone service at cost have yet to evaluate the full implications of the AT&T break-up. For the U.S. economy has changed from a "smokestack" industry to the information economy, from energy-intensive to energy-efficient, but more importantly than that the people of this great country have changed. What must not occur is that the affected industries allow these changes to occur without their knowledge. Utility executives must posture themselves in a proactive and not a reactive mode. They must posture themselves in a proactive and not a reactive mode. They must interpret these economic trends and political realities as inspriational as opposed to limiting. In fact, by viewing the macroeconomic changes as opportunities rather than threats, utilities can use their enormous though very dormant, competitive strengths to advantage in building a lion's share in the overall energy and telecommunication markets and thus returning to a point themselves paralleling historical growth .

The problem is straightforward: most utility companies are not managing their businesses as a market enterprise. In an industry

that it is so customer pervasive, the key issues commonly described by utility executives is maximizing their rate awards, bringing new plants on line speedily, upgrading technology and maintaining dividend increases for their stockholders. Very little is ever said about the "customer." I submit, the solution to the regulated industries' problem may be resolved, in large measure, by returning to the two basic principles of good marketing, giving the customer more value for their money, and expanding into new markets. Said another way, energy companies must (1) promote greater therm and kilowatt-hours use whenever it will lower average costs (2) go after those loads and customer uses which will increase the utilization of available base-load, fuel efficient generating capacity (3) strive to obtain a greater share of the total energy market; and (4) do all of the aforementioned in ways which are consistent with standards of wise, efficient use of energy while giving customers greater value for their energy dollar. The telecos marketing challenge is to develop a strategy to obtain large business customers by positioning themselves to meet their needs. The companies must be able to tell those customers, and demonstrate to them, that they can meet their perceived needs for lower rates or better service far more effectively than their competitors.

Returning to the competitive challenge of the marketplace will not be an easy task, since old habits may be hard to break. Unfortunately, the underlying changes in the economy that have altered the fortunes of these industries dictate a firm resolve. New strategies must be developed and pursued with determination.

As a regulator, I see several, promising, marketing approaches for the energy companies:2/

Going after the service sector which accounts for more than 50% of the GNP and continues to expand as it displaces the old "smokestack" industries. Focusing on high-profit growth is another approach. That is, increasing profitability by focusing on the different segments of the existing customer base. Identifying high growth subsegments of the market, targeting sales promotion to off-peak loads and focusing development efforts on high-margin commercial and industrial sectors. Another method is to capitalize on the new industries that have displaced the traditional high energy users. Utility marketing personnel could work with industrial customers to help introduce them to these technologies and to provide installation and service assistance if necessary. The telephone companies must endeavor to overcome the capacity limitations of the voice-grade network, in some instances this may be achieved through the mere addition of readily available electronics in others, through the use of new concepts in the integration of electronics into the system. The goal, to increase the capacity of the customer loop, the local switches and ultimately provide a possible fully integrated, all-digital network, offering the full range of services for all subscribers. And finally a marketing approach in the energy area whose time may have come, and that is, competitive pricing. I believe that the regulated energy industries can play hardball with regard to price as it relates to competing oil suppliers.

2/ These marketing approaches were discussed by Craig R. Johnson in a Public Utilities Fornightly article dated July 7, 1983

Although head-to-head competition may be plausible perhaps a more viable solution for utility management should be in developing strategies that outflank the competition with price and service differentiation instead of designing rates based on customer classification, perhaps it is time for the energy industry to provide different types of services. Such as a "premium service" that insures higher reliability and a minimum of surge problems. A "standard service" with high reliability priced where possible on a time-of-day basis to provide lower rates for nighttime heating loads. A "basic service" category where the customer's demand levels are contracting for at a lower price, designed for such essential needs as heating, cooking or cooling. And an "economy service" which is the traditional interruptible service and off-peak power. 3/ Several utilities, including Detroit Edison, New England Electric System and Pacific Gas and Electric Company have begun to put these concepts into practice.

The energy utilities are fortunate to have as many emerging opportunities to increase off-peak therm and kilowatt-hour sales as they do. The key is that each of the regulated industries must take advantage of any opportunities. Utility executives must wake up to the realization that they are comparable to firms in any other industry. They must, therefore, go out into the marketplace and find additional sales by promoting those end uses for which they can meet the requirements of customers at a competitive price. No company, no matter what industry it is in, can succeed without marketing and without being committed to satisfying an always changing set of customer needs

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3/ These pricing concepts were discussed by Johnson, supra at p. 13

and requirements. What must be appreciated and accepted today is that as competitive forces in the industry build and as the battle for customers' business intensifies, it will be absolutely essential to approach the marketplace with a creative marketing strategy. Regulated utilities will have to generate their revenues and profits the old-fashioned way, they must earn it. They will have to give consistent and meaningful attention to customers' needs. They must find new and creative ways to give the consuming public what they are looking for, because if not, the customers will look somewhere else. am hoping that in the near future, market and customer relations functions will be elevated to a priority status and have the full attention of Chief Executive Officers. Hopefully, marketing and **customer** relations executives will command the same status and rank within the corporate structure as do chief financial and engineering officers.

An what do we regulators need to do to adjust to this massive transformation. It would seem that it would be to everyone's advantage that these regulated utilities be given enough flexibility to compete in the market. The present ratemaking process effectively determines market and rate design - the very areas where a competitive response originates. We regulators need to realize, just as members c the industry must, that the market for utility service has changed in very fundamental ways and that many regulatory practices are rapidly becoming obsolete.

It is crucial, therefore, that utility executives begin the process of educating regulators as to the real world requirements. The industry must bring, we the regulators, into the planning

stages of the newly competitive utility strategy to secure our understanding and thus our support. You must demonstrate that the new strategy will not be used to justify unneeded costly construction, or result in anti-competitive abuse in the market place. You must convince us that pricing flexibility is an acceptable and appropriate approach. If you fail at this task, I can assure you that not only will the "winds of change" gather force but they will, in fact, pass us by.