Seven Steps for Achieving Sustainable Cost Reductions

Key Elements for Success

August 2017
Introduction

- Slow economic and demand growth coupled with increased penetration of distributed energy resources (including energy efficiency) has resulted in declining energy industry sales and revenues
- Many companies have witnessed their non-fuel O&M costs increase in the face of rapidly declining generation and sales, creating an unsustainable environment (see charts below)
- To avoid increasing energy rates and further eroding sales, companies are looking to reduce costs to meet shareholder expectations
- This document provides an overview of the steps that you can take to achieve sustainable cost reductions

Note: Data is comprised of approximately 140 investor-owned utilities
Source: SNL.com
Introduction (Cont’d)

- To achieve significant, sustainable savings a methodical approach is important:
  1. Establish and communicate the cost-reduction imperative
  2. Gain senior leadership alignment and support early in the process
  3. Determine your cost-reduction approach
  4. Document and communicate your cost-reduction roadmap
  5. Establish a phased process that focuses on sustainable, transformational change
  6. Conduct the cost-reduction exercise “top down” and “bottom up”
  7. Ensure long-term sustainability by building savings in budgets and initiatives in business plans

This approach helped one client save more than $500 million in annual O&M costs
Step 1: Establish and Communicate the Cost-Reduction Imperative

- Establishing and communicating an easily understood imperative will help to ensure buy-in at all levels.
- One approach is simply illustrating the unsustainable environment of increasing costs relative to flat-to-declining revenues (see charts on previous page).
- Another approach is using shareholder expectations to help to communicate the need for cutting costs, e.g., comparing Management aspirations for earnings per share (EPS) to industry and/or analyst expectations (see chart below).
- The gap between the analysts/industry forecasts and management’s EPS goals can be converted to cost reduction and revenues requirements and highlight the need to further reduce costs.

![EPS Forecast Chart]

- Reduce regulated and non-regulated pre-tax costs.
- Increase regulated and non-regulated revenues.
### Step 2: Gain Senior Leadership Alignment and Support Early in the Process

Conducting a cost-reduction planning workshop with senior leadership will ensure alignment and support for the cost-reduction process.

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<td>Gain senior leadership alignment and support for the cost-reduction imperative</td>
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<td>Establish a common philosophy and understanding of cost-reduction expectations/priorities, approach, process, critical success factors, and potential issues among the leadership team</td>
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<td>Develop preliminary components of the cost-reduction roadmap</td>
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<td>Establish company readiness to “jump start” the cost-reduction process</td>
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<td>Cost-reduction objectives, goals, and scope</td>
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Step 3: Determine Your Cost-Reduction Approach

Four cost-reduction approaches are predominate.

- **Benchmark Driven**: Reductions set using functional or process benchmarks
- **Organization Driven**: New, leaner organizations are designed; headcount selected for all or new positions
- **Target Driven**: Top-down reduction targets are assigned to functions; functions individually determine how targets will be achieved
- **Process Driven**: Work elimination and streamlining through process redesign result in reductions

- Each approach varies as to its ideal application and time to implement
- Often, the best cost-reduction approach for an organization can be crafted using elements of each of the methods
- Regardless of the cost-reduction method, an ideal approach should:
  - Fit the organization’s culture
  - Achieve reductions with minimal impact on employee morale
  - Retain high-potential and high-performing employees
  - Ensure retention of organization knowledge that may not be well documented
  - Reduce work where necessary to ensure savings are sustainable
  - Remove poor performers
  - Once announced, stress frequent and meaningful communications
Step 4: Document and Communicate Your Cost-Reduction Roadmap

**Imperative and Objectives**
- Describes the needs for cost reduction and the desired outcome
- Provides clear understanding of cost-reduction needs and objectives to employees, customers, and other stakeholders
- Clearly identifies organizational priorities

**Decisions Already Made**
- Communicates key organization, operations, and infrastructure decisions that have already been made
- Provides clarity for participants during detailed design and implementation plan development

**Critical Success Factors and Principles**
- Defines success and what principles are to be followed during the cost-reduction process
- Communicates an understanding of organizational values, beliefs, and philosophies

**Approach, Process, and Timeline**
- Defines the approach and process by which cost-reduction initiatives will be identified and documented
- Identifies and brings together key corporate planning and cost-reduction milestones
- Sets the pace and cadence for the cost-reduction process

**Implementation Priorities and Critical Milestones**
- Describes leadership’s expectations for implementation priorities
- Identifies critical implementation milestones to achieve cost reductions

**Management Structure and Roles**
- Clearly defines roles and responsibilities for all participants
- Establishes decision rights and the decision-making structure
- Defines the interfaces of various resources and efforts within the cost-reduction process
### Step 5: Establish a Phased Process that Focuses on Sustainable, Transformational Change

#### Phase I: Establish the Cost-Reduction Imperative
- Define strategic issues and the need for reducing costs, e.g., sales/revenue forecasts vs. costs, etc.
- Define what success looks like to address strategic issues (economic and non-economic)
- Establish corporate-wide cost-reduction goals
- Determine cost-reduction approach and scope
- Identify preliminary areas for improvement (cost reduction and organizational performance)

#### Phase II: Develop the Blueprint
- Establish the cost-reduction framework and communications plan
- Perform current state assessment (cost and headcount trends)
- Finalize improvement areas (cost reduction and organizational performance)
- Establish business unit cost and staff baselines and reduction targets
- Develop functional guidance and design criteria

#### Phase III: Perform Detailed Design
- Identify and document cost-reduction initiatives
- Define and document impacts to service levels (boundary issues and stop doing) and risks
- Define organization design guidance, e.g., principles, spans/layers, job title alignment, etc.
- Finalize and recommend detailed organization design and staffing levels
- Define performance metrics
- Establish business plans and future year budgets

#### Phase IV: Implement Designs
- Implement business plans and cost-reduction initiatives
- Implement staffing, change management, and facilities plans
- Monitor implementation and track results

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### Why do we need to change?
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- What are we expected to achieve?
- How fast and how far?

### How will the cost-reduction effort be structured and managed?
- How will the cost-reduction effort be structured and managed?
- What is the current state?
- What are the targets and opportunities?

### What actions must be taken to get us there?
- What actions must be taken to get us there?
- Have we considered all constraints and dependencies?
Step 6: Conduct the Cost-Reduction Exercise “Top down” and “Bottom up”

Senior leadership should set the “top down” expectations
- Select the expected approach to complete the exercise
- Define the timelines required for the process
- Set targets/parameters on cost savings and organizational changes

Final plans should be challenged by the leadership team prior to approval
- Leaders from each functional area should present their approach
- Encourage peers from other functions to question and challenge everything, including plans, assumptions, targets, etc.
- Ensure everyone is maintaining an open mind, and adjust plans as needed

Create the most successful and sustainable plans by providing guidance and expectations, and then depend on your people to deliver on the details

Functional teams should build the plans “bottom up”
- Use top performers from multiple levels of the organization
- Identify the future managers of a function and involve them in the process as possible
- Provide the teams the resources and latitude they need to be successful; encourage new approaches and ways of thinking
Step 7: Ensure Long-Term Sustainability by Building Savings in Budgets and Initiatives in Business Plans

**Budgets**
- Ensure cost reductions are included in future multi-year budgets
- Avoid making cost savings one-time “management challenges” or solutions to plug one-time gaps
- Track and report on the key drivers for budget (e.g., labor), especially if labor reductions are integral to savings
- Maintain monthly budget discipline and be rigorous in variance reporting and review
- Take the time to build bottom-up budgets to justify all costs for future years

**Business Plans**
- Build all initiatives into multi-year business plans
- Align strategic goals and cost-savings goals to avoid conflict and support success
- Create the right metrics to track initiative progress and report regularly
- Provide progress updates on actions taken on a consistent basis; report out to senior leadership at least quarterly
- Re-evaluate initiatives annually to make sure desired results are still on track

Do not lose the cost benefits of your teams’ plans by not maintaining momentum and discipline long term
Key Success Factors

- Obtain CEO support (a platitude, but essential), then gain support of his/her directs
- Establish a project structure with employee teams, one that is internally led. Consider the role of outside help—the project cannot be centered around consultants “chopping” costs, but consultants can help guide the process and help the teams achieve success
- Establish a great core project team with recognized internal leaders (e.g., Finance and HR, in partnership with consultants) to drive the process
- Set reasonable targets informed by clear rationale (such as benchmarking)
- Focus on sustainability in cost reductions, i.e., translate cost-reduction targets into potential labor reductions
- Make sure cost-reduction initiatives are “actionable” and clearly connect the path from current to the future budgets
- Track and monitor cost-reduction initiatives as they are being implemented to ensure they achieve cost savings
- Utilize standard tools and templates to expedite the process and ensure deliverable consistency and quality
Contact Us

ScottMadden can help you plan and execute your cost-reduction initiative

- Support for cost-reduction initiatives has been one of the core competencies of ScottMadden since its founding in 1983
- We recently assisted a large electric utility client in saving more than $500 million in annual O&M costs
- We have conducted myriad executive-level leadership team cost-reduction planning workshops
- We have significant experience assisting companies to successfully design and implement integrated operating models
- Our functional expertise in the energy industry is deep, and our consulting experience is broad—a combination we believe is unique in the consulting industry

Contact us to discuss any questions you may have.

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