After winning the most prestigious award in its industry, this utility company is driving itself toward even more challenging goals—including the elimination of rate increases for the foreseeable future.

Deregulation, Reengineering, and Cultural Transformation at Arizona Public Service Company

SAMUEL M. DEMARIE  BARBARA W. KEATS

When a company wins the most prestigious award in its industry, it might well rest on its laurels. Such is clearly not the case with Arizona Public Service Company (APS), an organization that emerged from a series of morale-shattering reductions in force to claim the 1992 Edison Award.

The award had cited APS for its “transformation from a traditional rate-driven utility to a customer-focused company.”

Although the prize spoke eloquently of the company’s achievement, APS’s chief executive officer, Mark De Michele, knew that past victories would not help the company buffer a new surge of changes sweeping through the utilities industry.

By combining a deeper cultural transformation with leadership training and process reengineering, the company hopes to upgrade customer service, push costs per kilowatt hour down by 20 percent, and eliminate rate increases for the foreseeable future.

APS’s progress toward these ambitious goals is a story worth watching.

THE COMPANY AND ITS INDUSTRY

APS is the largest investor-owned utility in Arizona, with annual revenues in excess of $1.6 billion and approximately 7,000 employees. Throughout most of APS’s long history (its roots can be traced back to the 1880s), the company produced and supplied both elec-

The authors would like to thank Arizona Public Service Company for allowing us to publish this article, Mark De Michele and Scott Jacobson for their gracious support and cooperation, and John Slocum, Jr., Loren Gustafson and John Mullane for their helpful comments on an earlier draft of this paper.
tricity and natural gas. Currently, APS has limited its operations to include only the generation, production, distribution, and transmission of electric power. Headquartered in Phoenix, its service territory includes eleven of Arizona’s fifteen counties. APS uses fossil fuels as its primary source of power, but also participates as a managing partner in the state’s only nuclear generating plant.

Industry Perspective

With few exceptions, electric utilities historically functioned as regulated monopolies within governmentally determined territories—a stable, noncompetitive environment. Now, however, the industry is becoming increasingly deregulated, and many electric utilities are anticipating large-scale changes similar to those experienced by organizations in other deregulated industries—telecommunications, airlines, and financial services, for example. These companies suddenly find themselves facing head-to-head competition—and the need for a wholly new kind of strategy.

At the same time, other related forces are reshaping the industry:

Independent Power Producers. These small companies are not regulated and typically carry lower overhead and capital investment costs. Independent power producers (IPPs) achieve their competitive advantage by building electrical generation plants designed to serve the specific needs of a targeted group of large customers such as manufacturing facilities, mines, industrial parks, or universities. Because regulated utilities are mandated to maintain sufficient capacity to service all customers within a given territory, they find it difficult to compete with IPPs’ rates and service.

Wheeling. This term refers to government mandates that force a utility company with transmission lines in place to allow competitors, including IPPs and other electric utilities, to use its lines. Mandates of this kind seem to be receiving increased governmental support.

Regulatory Agencies. In recent years, the relationships between utility companies and their regulatory organizations have become more adversarial. The agencies now scrutinize—and frequently challenge—proposals for rate increases. Companies that historically raised customer rates whenever profit margins declined must now find alternative methods of maintaining acceptable returns to their shareholders.

Cogeneration. Some customers (usually large companies) generate their own power internally (using coal or natural gas, for example). Utility companies servicing these customers’ areas are obligated both to buy back any excess power generated by cogeneration and to maintain the capacity to supply power if the private sources become incapacitated or insufficient. This poses a double threat. Every megawatt of business lost means a utility’s fixed costs have to be recovered from a smaller customer base, which in turn increases the pressure to raise prices for the remaining customers. As electric rates increase, cogeneration becomes a progressively more attractive option for large customers.

EXHIBIT 1
THE “TOP 5 BY ’95” GOALS.

By 1995 APS will:

- Be one of the top five investor-owned electric utilities in America in terms of cost management, customer service, power plant performance, nuclear and industrial safety and environmental performance.
- Have significantly improved our price competitiveness.
- Have improved our competitive marketplace position.
- Be recognized as the premier corporate citizen in Arizona.

We will succeed through employee commitment to continuous improvement with emphasis on teamwork, workplace innovation, and corporate culture change.

We will accomplish this through strategic community involvement, high-impact employee volunteer efforts, and innovative environmental and educational programs.

Adapted from the APS 1994 Corporate Strategic Plan.
Environmentalism. Increased awareness of and sensitivity to the environment continues to impact utility companies. The most pressing challenges arise from (1) governmental pressures to reduce emissions of compounds such as sulphur dioxide and carbon dioxide, (2) public concerns regarding the safety of nuclear generators and the disposal of nuclear waste, and (3) the health risks posed by electromagnetic fields. Electric utilities face the task of finding effective ways to address these challenges without increasing their rates.

HOW APS COPED

APS's efforts to find appropriate responses to this new environment fall into three phases.

Phase I—Downsizing. During its 40-year history as a rate-based monopoly, APS faced only two main challenges: maintaining sufficient production capacity to service a rapidly expanding customer base, and obtaining adequate rate increases to offset rising operating costs. The predominant management style was control oriented, and the company culture reinforced employee assumptions of job stability and "employment for life."

When Mark De Michele assumed the role of APS's CEO in 1988, he found himself in charge of what appeared to be a healthy organization: revenues were 5.4 percent higher than the previous year, and profits were up 8.7 percent. But as De Michele developed multiyear projections and assessed likely future scenarios, a much different picture emerged. Unless the company made major organizational changes—and did so quickly—APS would need to seek a staggering 36 percent rate increase to recoup projected costs. And the current political climate made the probability of approval highly unlikely.

Benchmarking studies of other similar utilities suggested that APS was grossly overstaffed (9,000 employees versus an average of 6,000 among the other firms). A major reduction in force, the top management team determined, would be the best way to reduce costs quickly.

De Michele believed that layoffs should number approximately 3,000 and be distributed evenly among all major functions of the company, with the exception of the nuclear plant (for safety reasons). However, the officer group convinced their CEO to limit the targeted reduction to 1,500 positions (a net reduction of 1,200 people).

Driven by financial goals, the 1988 downsizing was virtually an across-the-board layoff intended to delay or reduce the need for future rate increases. The actual financial savings, however, came in well below expectations. The number of employees who accepted the early retirement offer far exceeded projections, adding unexpected costs. Moreover, many members of the management team felt that the company lost some of its most valuable employees. What management had seen as a "humane" approach to the reduction in force had unintended consequences.

According to De Michele, one of the most important lessons learned from the 1988 downsizing was "how not to do it." In reality, the survivors were expected to do more with less. Culturally, there was no real change—the organization retained a rate-based mentality, and morale plummeted. It soon became clear that a major restructuring was required.

De Michele felt that the demoralized work force needed to see the restructuring process as something in which they played a part, rather than as something that was being done to them. To accomplish this, De Michele met individually with large numbers of employees. His message was that survival in an increasingly competitive industry would require radical design change to the organization.

Moreover, the organization needed a tangible goal for the restructuring so that employees could focus on the initiative's potential positive outcomes. De Michele set an ambitious target—placing APS as one of the "Top Five" utility companies in the United States by 1995. "Top 5 by '95" became a rallying cry. Initially, the slogan was nothing more than a stage device for creating a sense of purpose and urgency. It was not until several months later (Fall of 1989) that De Michele
EXHIBIT 2
THE APS MISSION AND VISION

APS MISSION 1998 GOAL: THE LEADING ENERGY SERVICES PROVIDER
Our working definition for the leading energy services provider is:

Number 1 in each of our Top 5 by '95 core efficiencies.
The low-cost provider in Arizona and one of the three lowest in the Southwest.
The leader in providing new and innovative energy products and services to support and defend our competitive position.
Recognition by our customers, regulators and competitors as the leader in the industry.

APS VISION 2000
By 2000, we will be:
The leading energy service company in the USA.
The energy provider of choice in Arizona.
The acknowledged premier business in Arizona.
A model of strategic management and dynamic improvement both within and outside the energy sector.
Known nationally as a premier investment opportunity.

The areas of strategic emphasis are:

1992-1995   Our "core efficiencies" in the areas of cost management and safety.
To 2000     The Company of Ideas and Action—The Premier Business in Arizona. We will continue to be customer focused and to pay unswerving attention to continuous improvement and culture change.

Adapted from the APS 1994 Corporate Strategic Plan.

and his team grounded the vision in specific goals (see Exhibit 1).

During this same period, PacifiCorp (a northwestern utility) attempted a takeover of APS. Believing that a merger could save $500 million annually through the sharing of periodic excess capacity, PacifiCorp mounted an extensive advertising campaign that called public attention to APS's high rates and inefficient operations. Even though the publicity ultimately failed to muster support for the takeover, it sounded a clear "wake up call" and galvanized APS employees into a sense of community. Ironically, it gave urgency and vitality to De Michele's Top 5 by '95 vision. In addition, De Michele noted, it forced him to step up the implementation of his vision.

Early in 1990, De Michele established job review committees to evaluate every existing position in the company. The committees assessed each position's value to the overall organization and the qualifications required to perform each job effectively. They rewrote job descriptions to include not only technical skills and competencies, but also personal characteristics, such as flexibility and adaptability. Top management used the output to develop a new organizational structure that reflected 1,150 fewer positions and the elimination of two officers.

De Michele then chose a high-risk implementation tactic. He fired everyone, then required all employees (including himself) to reapply for the redefined jobs.

To enhance morale and keep employees involved, De Michele emphasized timely,
open communication with respect to which jobs had been filled, and which remained open.

Although De Michele saw the outcomes as positive, he soon realized that the changes had still not penetrated to the root of the problem. APS was still "doing what it had always done"—still operating as a rate-driven monopoly—only with fewer people.

**Phase II—The Focus Program.** As DeMichele looked to the future, he developed a "picture" of the kind of organization APS would need to become. His picture included increased cooperation among the departments and increased understanding among employees regarding the nature of the changing environment.

With the help of a consultant, De Michele and his management team set about the task of planning strategy, building a new culture, and developing a clear mission statement. Discussions between the consultant and the officer group produced two principal outcomes: the formalization of Top 5 by '95 into a central part of the company mission, and the creation of a special team to spearhead a program known as the "Strategic Cultural Change Initiative."

As a catalyst for cultural change, the team engaged employees in a program referred to as "Focus." Cross-functional teams of APS employees experienced week-long marathon simulations designed to increase their awareness of what it meant to operate strategically in a more competitive environment. Sessions culminated with each team proposing new projects to a top management group headed by De Michele. Each project had to be anchored in frame-breaking strategic thinking and designed to significantly improve operations at APS. The management team immediately voted to accept or reject each proposed project. This demonstrated the strength of management's commitment and conveyed a sense of urgency. The executives then assigned a management sponsor to each project accepted.

Originally, Focus was designed primarily for employees involved with customer service. The enormously successful experiences and excitement spilling out from these groundbreaking sessions led De Michele to engage all employees in the program. As a result, for the first time many workers felt truly empowered. Not only were they being challenged to improve APS, but also to assume ownership of their projects, present their proposals directly to the top management team, and receive immediate feedback. The Focus experience proved to be a powerful motivator.

The organization began to experience very real successes, including lowered costs, improved customer service, and reduced red tape. These improvements became increasingly visible to customers—and to the utility industry in general. Shortly after Focus ended, APS received the 1992 Edison Award. This award—the most prestigious in its field—is given annually to the electric utility that contributes the most to growth and development of the industry.

**Phase III—Breakthrough Leadership and Reengineering.** The Focus program inspired De Michele and the top managers to look beyond Top 5 by '95. Before they ended in 1993, the Focus sessions had helped generate a new set of goals that were labeled "Mission 1998" and "Vision 2000" (see Exhibit 2). These aggressive targets were considered essential to maintaining a positive competitive position amid ongoing change. Moreover, the goals would require far more radical and encompassing changes than anything the organization had attempted before.

Top management decided to use a two-pronged plan of attack to address this challenge. First, the company would need to prepare employees psychologically and emotionally to cope with the coming changes. This would be accomplished through a program known as "Breakthrough Leadership." Second, the company would need to redesign work processes throughout the organization, from the bottom up. Based on the concept of reengineering, this redesign effort would be far more radical than that attempted in 1990. The previous restructuring efforts focused almost exclusively on eliminating duplication of effort and inefficiencies within the current
EXHIBIT 3
APS Leadership Principles

Leadership must be concerned about what we will need in the future, combined with an intense focus on high levels of performance. Our management team is committed to the following leadership principles. APS leaders:

- Communicate, clarify, support, reinforce, and model our mission.
- Spend most of their time with their employees, focusing on their performance and results.
- Do not allow organizational or personal boundaries to get in the way and strategically empower others to act within the framework of our vision and targets.
- Make strategic decisions quickly, openly, and based on our values, mission, critical success indicators, and strategic priorities.
- Acknowledge mistakes and make necessary adjustments.
- Demonstrate behaviors consistent with a high-performing culture.
- Demand results from themselves and others and eliminate habitual activities that get in our way.
- Value a high level of business competency.
- Embrace and relish the concept of continuous strategic change.
- Demonstrate enormous energy and have the ability to energize others.
- Model the behaviors and commitment to the cultural diversity strategy.

Our future will be determined by our sustained vision, these leadership principles, and our will to apply them.

Adapted from the APS 1994 Corporate Strategic Plan.

structure and work processes. Reengineering, on the other hand, would discard the current structure and start over from the basics.

**Breakthrough Leadership.** To create a cadre of leaders, management selected three groups of about 80 people each to participate in the Breakthrough Leadership program. As criteria for the selection process, company officers developed lists of critical leadership characteristics that would reflect and support the company's mission, goals, and values (see Exhibit 3).

To involve the entire company in this program, management chose participants from all functional areas and levels in the organization and placed the recruits in cross-functional teams of ten members. Each team was assigned a leading edge book on management and/or corporate culture to read and discuss prior to the start of their week-long program. During the program, the teams presented what they had learned from their assigned reading and talked about how those principles could be applied.

A large segment of each program focused on reengineering concepts and on how integration of these concepts would impact the organization's culture. The process culminated in a full-day session devoted to a collective sharing.

**The Reengineering Process.** Two separate reengineering teams (one in the nuclear power plant, the other in transmission and distribution operations) pioneered the redesign effort. The relatively clear definition and complexity of current structure and processes within these two areas, coupled with projected cost savings (in excess of 30 percent) suggested that these were good candidates for reasonably visible "wins" in a relatively short time frame.

The teams started with a "blank sheet of paper" and totally recreated the workflow in their areas, with the goal of simplifying work
processes. They mapped out current work processes, then developed plans for a totally new flow of work. Implementation of these plans is currently in progress.

FUTURE PLANS
Impressed by the new work-process designs the two teams have produced, APS executives are planning a broader, organization-wide reengineering. To support this expansion, they are aggressively extending the cultural change program to include new “Breakthrough” sessions. Management hopes that, together, these two initiatives will be the catalyst that completes APS’s transformation from a rate-driven monopoly to a strategically directed, competitive company.

APS executives have set three primary measures to gauge overall success. First, they project that the programs will result in a decrease in APS’s overall cost per kilowatt hour from the current 9 cents to 7 cents. Second, the programs will provide an improvement in overall customer satisfaction (as measured by an independent customer survey). Finally, they anticipate that the programs will allow them to eliminate planned rate increases for the foreseeable future.

APS has graciously agreed to allow us the opportunity to revisit their organization next year to report the progress they have made toward these goals.

If you wish to obtain reprints of this or other articles in Organizational Dynamics, please refer to the special reprint service instructions on page 80.

About the Authors

Samuel M. DeMarie is a doctoral candidate in strategic management at Arizona State University. His research interests include strategic change processes, downsizing, restructuring, and organizational identity. He has published articles in the Academy of Management Review and the Academy of Management Executive and has presented competitive papers at national and regional meetings. He is currently working on his dissertation, which focuses on downsizing and organizational identity.

Barbara W. Keats is the associate dean for research and administration in the College of Business, Arizona State University. Her research focuses areas are strategic management and organizational design. She has published in leading management journals, such as the Academy of Management Journal, Strategic Management Journal, Organization Science, Journal of Management, Decision Sciences, and Journal of Applied Behavioral Science. Professor Keats served as a member of the editorial review board of the Academy of Management Journal for six years, and the executive committee of the Business Policy and Strategy Division of the Academy of Management for a two-year term.