

The role of **regulation** in strategy

Companies have everything to gain from linking them.

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For companies in many nations, regulatory policy increasingly shapes the structure and conduct of industries and sets in motion major shifts in economic value. In network industries such as airlines, electricity, railways, and telecommunications, as well as in banking, pharmaceuticals, retailing, and many other businesses, regulation is the single biggest uncertainty affecting capital expenditure decisions, corporate image, and risk management.

In the electric-power industry, for example, the smallest price revisions can have a dramatic impact on corporate profits. So can the structural transformations, brought on by liberalization, that have created new markets for independent power producers and retailers. In pharmaceuticals, new US Medicare rules are forcing drug companies to rethink their product and pricing strategies; in the food industry, pressure to regulate fast-food advertising aimed at children is influencing the marketing strategies of producers, retailers, and restaurant chains.

In many respects, regulation reflects an explicit, formal contract between business and society. Even in the absence of laws and regulations, informal agreements may call upon companies to meet certain social responsibilities. As the food industry is learning, the failure to fulfill these obligations—or new ones created by a change in society's needs or priorities—can propel a shift from self-regulation toward explicit rules.¹ Societies form regulations through an ongoing negotiating process that seeks to reconcile the often conflicting objectives of governments and stakeholders (such as companies, consumers, unions, and environmental organizations), many of which have considerable influence. Successfully navigating this process can allow companies not only to manage regulatory risk but also to shape their industries and to create potential opportunities for themselves.

Despite the increasing importance of regulation, many businesses, even in heavily regulated industries, treat regulatory strategy as more art than science. Many lobby and conduct public relations on an ad hoc basis without the benefit of hard facts or a clear understanding of the trade-offs; others adopt a fatalistic or confrontational approach to industry regulators. Many companies, focused as they are on next quarter's earnings, view regulatory issues as a longer-term challenge that will either go away on its own or be dealt with in the future. Moreover, most companies tend to make regulatory management the domain of specialists—lawyers, technical experts, and public-relations people—who, essential though they are, almost always lack a holistic view of how regulation affects corporate strategy.

Companies struggle with their responses to regulatory challenges for several reasons. First, the issues are often extremely complex and interdependent. Moreover, when deciding on a regulatory stance, companies must consider complicated trade-offs between maximizing profits and broader social and economic factors while at the same time taking into account the interests of a number of stakeholders. Finally, the job is made no easier by constant uncertainty about future regulatory changes—uncertainty exacerbated by tensions among stakeholders and by unforeseen events, such as the emergence of disruptive technologies, rapidly evolving social trends, natural disasters, and changes in governments.

Companies can overcome these obstacles by making regulation a core element of strategy. Doing so requires a deep knowledge of the economic, social, and strategic impact of regulation, an understanding of other stakeholders so that coalitions can be built to support a chosen regulatory strategy, and a new organizational approach that puts regulation on the agenda of the CEO and the top team.

The value at stake

The impact of regulation and regulators is evident in many industries (Exhibit 1).

Power. The implementation of the Kyoto Protocol is beginning to reshape energy markets around the world. In the European Union alone, a cap-and-trade scheme to meet targets for greenhouse gas emissions has

EXHIBIT 1

Industry by industry

Selected regulatory issues by industry

Power

- Implementation of Kyoto Protocol
- Capacity regulation
- Transmission regulation (networks, distribution)

Natural gas

- Long-term diversified supply

Pharmaceuticals

- Product approval
- Drug reimbursement
- Market entry of generic drugs
- Marketing

Transportation and logistics

- Deregulation of rail freight industry in Europe
- Network access in postal and rail

Food

- Advertising of junk food

Telecom

- Pricing, bundling of Voice over Internet Protocol (VoIP)
- Network unbundling
- Mobile-license renewal

Insurance

- Solvency requirements
- Federal charter proposal in United States

Financial

- Basel II capital requirements
- Single market for retail financial products in European Union

Petroleum

- Barriers to available resources
- Environmental compliance

Basic materials

- Implementation of Kyoto Protocol
- US antidumping act (steel industry)

Source: Interviews; McKinsey analysis

created a multibillion-euro market for the certificates that allow a company to emit a certain amount of carbon dioxide. This system has reshaped the incentives for electricity production as generators switch from coal-burning to natural gas-fired plants to achieve lower levels of carbon dioxide emissions, for example. The strategic landscape is being redrawn as a result.²

More recently, high oil prices and the destruction wrought by hurricanes in the United States have highlighted the role that regulation has played in constraining refining capacity there during the past 20 years. This new reality will almost surely cause regulators to reevaluate these constraints, as well as alternative energy sources.

Food. With the rate of obesity increasing rapidly in many developed countries, the food industry is facing a sea change, from what had been a set of implicit contracts with society to more explicit regulatory remedies and to questions of legal liability. The EU Commission is demanding that the European food industry stop advertising junk food to children and improve the labeling of products or face new legislation. Calls to ban vending machines that sell soft drinks or junk food in schools have been heard from California to France to the United Kingdom, where a measure of this sort is slated to take effect next September. Initiatives like these, and the debate at large, may also create opportunities for smaller players—to produce healthier food and position themselves as an alternative to the market leaders, for example.

Pharmaceuticals. In few industries does regulation play a more important role than in pharmaceuticals, where a single blockbuster drug approval can be worth tens of billions of dollars. Combine this dynamic with highly charged issues (such as stem cell research, the affordability of

drugs, rules surrounding generic products, and access to vaccines in poorer countries) and it is clear that a pharma company's reputation, investments, and profits are on the line daily.

Regulatory disruptions, such as US Medicare reforms that will take effect in January 2006, complicate matters further. For the first time, the federal government's medical-insurance scheme for the elderly will provide prescription drug coverage. This program could potentially involve 43 million US citizens, who account for \$78 billion, or 16 percent, of global industry revenues. Although drug sales could rise in the short term, the new system will increase pressure on prices because the federal government will be indirectly responsible for purchasing about half of all pharmaceutical products sold in this market. Moreover, the plan lowers the barriers against cheaper generic drugs. Pharmaceutical companies are pondering the discounts they will have to give insurers to be included as suppliers; some, for example, are already expanding their generics businesses to tap into this opportunity.

A regulatory strategy

The far-reaching impact of regulation means that for companies to maximize their long-term value, they must link up their regulatory strategies with their product, business unit, and corporate strategies.

Otherwise, they will often fail to keep their finger on the regulatory pulse, and the result could be ineffective and desultory responses to the opportunities and risks posed by regulation.

Consider, as a cautionary tale, the speedy regulation of fees on cross-border payments in the eurozone after the introduction of the euro, in 2002. Although it was no secret that the European Commission was eager to demonstrate the benefits of a single currency, banks in Europe failed to anticipate, and were therefore unable to influence, a new rule specifying that an institution could charge no more for cross-border transactions than for national ones. In many markets, national payments had been provided without fee, while cross-border transactions carried a charge to cover the extra expense, so banks were hit by costs they couldn't recoup from customers.

Companies must address three crucial dimensions to integrate their regulatory strategies.

- First, they need to diagnose each issue in the current and long-term regulatory landscape and develop a heat map. Combined with thorough insights into the economic, social, and strategic impact of different regulatory outcomes, such a map can help them identify their objectives.
- Second, they must understand the competing agendas of important stakeholders and create a consensus within the constraints of probable regulatory outcomes. This step is essential if companies are to translate their own priorities into feasible compromises, even if compromise isn't their first choice.
- Finally, companies must make regulatory management a constant process that is integrally linked to strategic functions and run by a high-level executive with a strategic perspective and easy access to the CEO. Only then can they shape future regulations by serving as a thought partner for regulators and other stakeholders, who may not be aware of the consequences of well-intended regulations.

Defining and understanding the impact

The quest for a detailed understanding of the issues should typically start with an exercise attempting to clarify the main regulatory areas that could affect the business, both today and within three to five years, as well as the positions of the major stakeholders, the level of uncertainty in each area of regulation, and the impact on the company itself and on other stakeholders. This examination should include regulatory disruptions that could change the game, such as the new US Medicare reforms, as well as technological developments likely to affect regulation (for example, the impact of internet telephony on prices for fixed-line service). Effective assessment must include outcomes—such as prices, employment, the quality and availability of services or products, investment levels, receipts from privatization and taxes, and the industry's competitive intensity—that are important to other stakeholders (Exhibit 2).

Consider this process from the perspective of one European electrical utility before the Kyoto Protocol's implementation. In preparation for the launch of the emissions-trading market, in 2005, the European Commission asked each EU member state to design a plan for allocating carbon dioxide emissions certificates among companies. The national plans, which were allowed to vary from country to country, were created through close consultation by government ministries, regulatory bodies, and the private sector.

The European utility used simple rules of thumb to evaluate the importance of the issues, including different ways of apportioning certificates. The alternatives ranged from allocating carbon dioxide allowances in accordance with to a plant's electricity output (which would favor, for example, clean and efficient natural gas-fired generators over coal-burning plants) to basing them on historical emissions levels regardless of the fuel used. The potential options had vastly different implications for the company's return on its existing generation assets and would also affect its future investment strategy.

Having identified and prioritized the key issues, the utility then subjected each of them to complex modeling that assessed the effects, financial and otherwise, of the possible regulatory outcomes on the business, its competitors, government stakeholders, consumers, and the environment. The results of such an analysis are often surprising. The electrical utility recognized the importance of pursuing an allocation model that rewarded clean-power generation in its home market. Yet viewing the design of national allocation plans in its other markets from a holistic perspective was equally essential. The age and fuel technology of the company's generation assets—and thus its regulatory preferences—differed among the countries where it operated. The ultimate design of the various allocation plans highlighted arbitrage possibilities in replacing capacity or building new capacity in neighboring markets as well as in reimporting electricity through the European power grid.

Managing the stakeholders

Knowing what's important and achieving positive outcomes are two different things. The latter requires the ability to bundle issues and to balance their relative value for different parties and thereby create favorable trade-offs and build effective coalitions.

EXHIBIT 2

Sizing up regulatory outcomes

Impact of 2 regulatory scenarios on a disguised telecom market and its stakeholders; index: status quo = 100

Sector development

- Regulatory scenario 1
- Regulatory scenario 2



¹Corporate taxes paid by companies in sector.

For the European utility, affecting the outcome meant giving up its first preference for the design of the allocation scheme and going for the second-best option, which only partially favored its clean-generation assets. In addition, the utility aligned itself with influential government bodies by supporting their wish for a relatively large national reserve of certificates,³ which meant a smaller allocation for the utility itself. In essence, the company was willing to trade relatively unstable gains from selling allotted certificates at a profit against a financially manageable outcome, backed by a stable coalition, that probably wouldn't be subjected to constant regulatory changes.

Stakeholder management—a vital part of an effective regulatory strategy—depends on creativity, experience, and judgment. A systematic process can handle this challenge consistently and effectively, and, if done well, delivers big benefits. A North American energy player, for example, faced a new round of pricing negotiations, a process that can go on for weeks or months as conflicting parties wrangle over estimates of the utility's costs and the prices needed to guarantee a reasonable return on its investments. This time, however, it won approval within a few days for its proposal to replace the traditional cost-based regulatory framework with one based on performance and on sharing efficiency gains with customers. The company negotiated in advance with all major stakeholders, including corporate and residential customers and environmental groups. It went on to achieve regulated investment returns that were 195 basis points above the industry average.

In general, successfully managing stakeholders involves three steps.

Conducting stakeholder analyses

By using results from an analysis of each regulatory issue's strategic and economic impact on stakeholders, companies can look for patterns of future cooperation and conflict as well as mutually beneficial trade-offs. The results, in turn, help identify various combinations of issues, outcomes, and coalitions that would support these trade-offs.

For more about working with—and not around—stakeholders, see ["Controversy Incorporated"](#)

Several tools can help companies build a comprehensive understanding of stakeholder agendas. The first, a traditional way of looking at all of the regulatory levers and evaluating the impact of different outcomes on key stakeholders, should be obligatory due diligence for larger players. The second tool uses social-network theory to identify opinion shapers—scientists, academics, technical

experts, and specialists from nongovernmental organizations—who support policy makers on complex issues. Finally, traditional consumer-marketing techniques (using focus groups to segment consumer attitudes, for example) can prove beneficial when consumer perceptions of corporate practices are an important factor.

The North American utility recognized early on that for its plan to succeed, it would have to reconcile the objectives of the different stakeholders. The utility was interested in a stable and financially advantageous

outcome and in good long-term relationships with the other stakeholders. Corporate customers were interested mainly in lower prices, while residential customers wanted lower prices and state-of-the-art, environmentally friendly solutions. The regulatory authority, meanwhile, was looking for cost-efficient electricity production, lower prices, and environmental gains. All the parties, naturally, wanted an ongoing say in designing and managing the scheme.

Managing trade-offs

The next step toward effective stakeholder management is deciding on an achievable outcome by taking into account the trade-offs between maximizing profits and broader economic and social considerations. In the case of the North American utility, sophisticated mechanisms to share efficiency gains with business and residential customers proved to be a satisfactory solution for all parties. Under the approved framework, the regulator sets the utility's efficiency targets. Gains below them automatically translate into lower prices that the utility can charge customers, but performance improvements above them are shared between the utility (in the form of profits) and its customers.

These arrangements give the company a strong incentive to provide its services more efficiently. Through additional price cuts, corporate customers benefit from gains above the preset target, while residential customers enjoy a combination of reduced prices and added services, such as subsidized insulation for their homes. An energy efficiency fund, financed by the utility's efficiency gains and created as part of the agreement, provides money for these services. Environmental and residential-customer groups, which report to the regulator, run the fund. Each stakeholder obtains tangible benefits from the plan and shares responsibility for its long-term success.

Communicating the strategy

Once a scheme has been decided on, the final step is to define and execute communications strategies for the relevant stakeholders. The North American utility opened a direct and constant dialogue with its major stakeholders while designing the proposal. A campaign can include a mix of bilateral or round-table discussions, traditional lobbying, and advertising, to name just a few possibilities. But we find that a well-designed campaign has several characteristics: it highlights facets of the regulatory outcome that stakeholders value while being honest about the company's own interests; and the communications strategy, based on facts and on a deep understanding of the stakeholders' interests and sensitivities, is presented in a consistent way by management.


Organizing regulatory management

Coordinating the elements of a successful regulatory strategy almost always forces companies to redesign the regulatory function.

There is no single recipe for doing that: some companies maintain regulatory units employing hundreds of people, while others have just a handful of specialists. Each company must adapt the function to its organizational structure, the role regulation plays in its industry, and the skills it needs to manage regulatory issues well. But the regulatory function, no matter how large or small, should be run by a high-level executive who can assess the options holistically against the company's performance and who has access to the CEO and to people with the right skills, either in a separate unit or spread across the company.

Only by raising the regulatory function's profile within the organization can companies ensure that their regulatory policies are integrally linked to their strategies and risk-management processes, as well as to tactical decision making at the business unit level. A higher profile also signals a considerable expansion of the regulatory function's scope, beyond the traditional role of compliance and periodic interaction with regulators. Sometimes a separate regulatory unit is required. An Eastern European telecom incumbent, for example, found that to address the challenges of market liberalization successfully it had to tap an up-and-coming manager to lead a staff pulled together from its legal, financial, technical, and commercial units.

The expanded role of the regulatory function is designed to catapult the people who serve in it from a specialist career track to one firmly on the map of executive-development programs. Several major companies have appointed executives with backgrounds as regulators or regulatory officers to top-management positions, thereby sending a strong signal about the importance of regulatory management.

Companies have everything to gain from forging a strong link between regulation and strategy. By shifting their approach to regulation from confrontation or passive compliance to a proactive and informed dialogue with external stakeholders, they can help construct more balanced regulatory frameworks and ensure a better outcome for the organization. 

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Notes

¹Ian Davis, "What is the business of business?" *The McKinsey Quarterly*, 2005 Number 3, pp. 104–13.

²The 1997 Kyoto Protocol is an international agreement that aims to reduce the greenhouse gas emissions of developed economies, from 2008 to 2012, by at least 5 percent from their current aggregate levels. The European Union's cap-and-trade scheme, which is mandatory for more than 5,000 energy and industrial plants, sets an annual limit on the aggregate amount of greenhouse gases a plant may emit. Each year, plants must ensure that their total emissions don't exceed a prescribed limit. They receive certificates for most of their emissions but either have to buy the remainder on a market regulated by the scheme or pay a penalty. For more details, see Enrique de Leyva and Per A. Lekander, "Climate change for Europe's utilities," *The McKinsey Quarterly*, 2003 Number 1, pp. 120–31.

³The federal government holds some emissions certificates in a national reserve to be used for future activities and for emergencies.

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