

OPERATIONS

COMPLEX SERVICES AND STRATEGIC SOURCING UNITE

By Vance Scott and Everett Johnson

Companies in many industries use strategic sourcing practices—that is, developing long-term relationships with contractors for planning and managing product or service procurement from a systemwide “strategic” level to complement a company’s larger goals. In most cases, by sourcing from a strategic level instead of purchasing materials and services on a localized, as-needed basis, companies have cut procurement costs from 5 to 10 percent per year on average.

Utilities, too, have achieved significant benefits from strategic sourcing, but not in comparison to other industries. (See Figure 1.) The primary reason for this “value capture” gap is that utilities have unique challenges in sourcing their more complex service categories. For example, plant maintenance and construction of transmission and distribution are large, multifaceted projects, requiring specialized skills and often using a blend of internal and external resources. Large utilities might spend more than \$100 million a year per complex service category, but because the company deems the service “core” to the business, supply chain and procurement options remain limited.

A key sourcing process is the selection of a contractor for these complex services. Many utilities push the decision-making down to local operating units. This is based on the assumption that the people closest to the day-to-day work have the most immediate knowledge about the work and should be responsible for the selection.

But local decision-makers tend to be risk averse, which often derails sourcing initiatives for complex services. You can trace this tendency to how local manage-

ment teams measure system reliability: They rightfully place a premium on minimizing unplanned system interruptions and maximizing customer satisfaction. They consider a systemwide solution to be a risk—it may help the corporation but could adversely affect customer service or create cost overruns. Why not just stick with a known contractor that has been

able to get the job done? But it is a superficial consideration.

Also, when spending takes place at the local level, sourcing efforts cannot capture the benefits of volume concentration—you have lots of little bills rather than one with a volume discount. With such fragmentation, too, utilities cannot focus on the most efficient use of internal resources; and there is limited (if any) systemwide

integrated planning with contractors.

Moreover, the complexity of the work and the many different local work practices prevent the company from capturing a systemwide set of performance metrics. Although many companies have developed project-based work standards for their own crews, few collect performance data regarding contractors across different classifications of work and geographic regions.

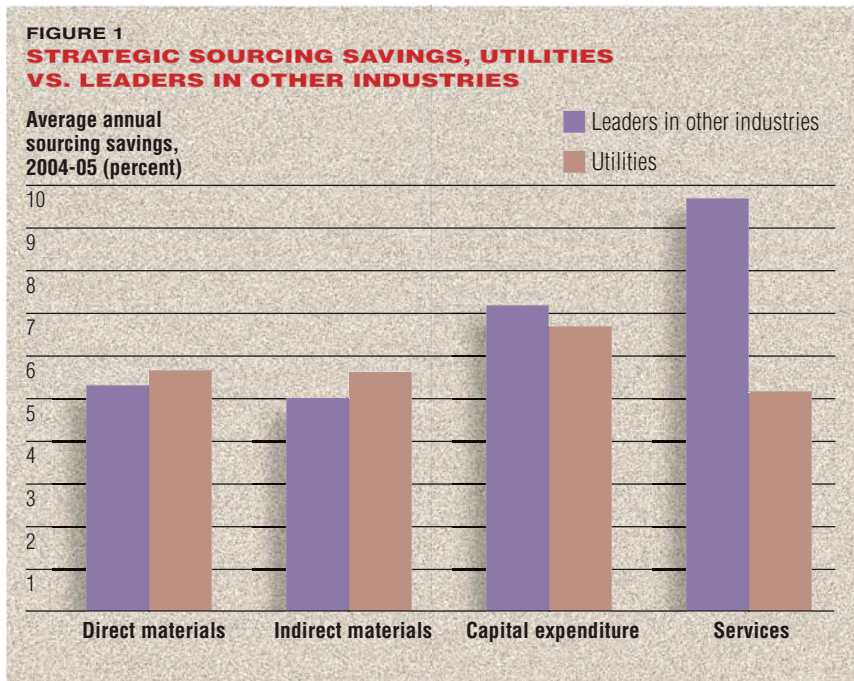
The Problems With Current Practices

Utilities usually award work in complex service categories using two tactics.

The first is project-by-project, using a closed bidding process. The point is to minimize costs by obtaining several bids from viable contractors. Such a process creates a competitive market environment, which takes advantage of the supply and demand imbalances that exist within a

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The authors are consultants with A.T. Kearney. This article is based on A.T. Kearney’s survey, “Assessment of Excellence in Procurement.”



contractor's book of business. Indeed, utilities often point to a cadre of projects where the winning bid was 10 percent or more below the remaining bids.

The advantage of a fixed-price contract is that it puts an upper boundary on the project cost (from the utility's perspective) and creates a competitive situation for labor costs and project execution. The problem is that fixed-price bid contracts have embedded risks that offset the certainty. For instance, because the contractor must bid on an already created project plan and usually has no input in making that plan most efficient, both parties often overlook mutually beneficial productivity and performance improvement or innovation opportunities. In other words, contractors make assumptions about labor costs and productivity and then add a contingency to protect themselves from the unknown risk. Meanwhile, the utility loses opportunities to refine the project scope, optimize resources and timing, or

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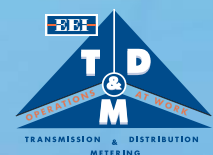
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reduce indirect costs. As the project progresses, contractors capture the benefits that result from positive performance variances and bill the owner for changes in scope or for undisclosed conditions that impede progress. As a result, most of the productivity and performance improvement benefits accrue to the contractor, with few rewards for the utility.

An alternate tactic is a time-and-material arrangement with a local contractor—an approach used when the project's scope is undefined or its needs are unpredictable. Over the years, local managers have developed relationships with local contractors to provide services for emerging work. Once decision-makers find a competent and responsive contractor, little real competitive activity exists.

In the end, using these two tactics to award work has created obstacles for supply chain managers in utilities, leaving them with few options to cut costs in complex service categories.

A Better Path

Strategic sourcing for complex services applies more rigor than those two tactics.

The first step is to develop a *spend baseline* by category—the amount of money a utility spends on a given service, considering both historical and anticipated spend. This may be difficult to determine—complex services are usually managed at the local level, are sometimes performed by internal resources, and may vary significantly from month to month or across locations. For example, demand for generation plant services might peak during the spring outage period, but needs still exist at specific sites throughout the year. In some situations, utilities use internal resources to perform this work even if this is not the most cost-effective way to match skills with duties.

To generate a spend baseline, the utility considers which activities are core to its operation (that is, activities that internal resources should perform), what the appropriate staffing levels should be, and how the internal resources will work across regions. In addition, the utility has

to consider what it has historically spent for external sources.

This is a challenge, but it pays dividends in the long run because it allows the utility to communicate the size of the potential opportunity to potential suppliers and creates the maximum leverage for competitive pricing. Using the spend baseline as part of a request for proposal (RFP) process is often an eye-opener—particularly when a noncompetitive environment exists at sites that have used contractors for many years.

Arguably the most important phase of the sourcing process begins after the company has received all suppliers' completed RFPs—when the utility negotiates the best solution using a *total cost of ownership* model. Here, the company considers the benefits it achieves through reducing mark-ups and improving productivity

and then balances them with the risks associated with supplier selection. The amount of mark-up reductions can be tempered by policy decisions around labor agreements, for example, as well as things like skill levels. For instance, although the difference in open-shop (nonunion) versus closed-shop (union) straight time labor can be as much as 20 percent, a company may not be willing to alter its labor strategies. In addition, many contractors are willing to commit to productivity improvements over time, which can take the form of improved project management efficiency (total hours to complete work) and worker effectiveness (“wrench time,” which is commonly below 30 percent for utilities).

The utility must *evaluate* the risk of taking on unfamiliar contractors. Moreover, it has to vet references against a set of selection criteria. In some cases, the utility may forego hard cost savings to mitigate risk.

Simply moving as much business as possible to firm price is not the best solution—the arrangement with the contractor

must create an environment of *continuous improvement*. To drive the improvement, the utility provides the contractor with an incentive that creates goal alignment with the utility. The company also establishes clear expectations for the contractor and defines year-over-year improvement. Finally, ongoing performance measurement is imperative; the utility must assess contractor productivity and technical limits for executing the service.

Improving Complex Services

The most successful companies know that the strategic sourcing process requires a team of field and corporate stakeholders, a fair amount of time (especially if they've never compiled baseline spend data), and a rigorous evaluation of alternatives.

They also know that the world is changing. From now on, it is no longer enough to reduce cost structures. Success, if not survival, depends on improving complex services. ♦

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