

Now More than Ever: The Case for Alliance Partnerships

By Parvez Patel and Robert Zabors

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In recent years (now known as ‘the good old days’) as utilities focused on capital projects to meet projected load growth¹, managers of supply chains faced a two-front battle – investing in growth while managing existing assets. They faced a difficult set of challenges:

- Increasing supplier power due to labor shortages and consolidation of service & materials providers
- Rising fuel costs that increase parts and service costs²
- Volatility and increases in commodity prices, as global markets forecasted tight supply and increasing demand, driving up costs for key components in generation, transmission and delivery
- Aging infrastructure and aging workforce
- Stricter compliance while facing uncertainties of future regulation and technologies (e.g. Smart Grid)

For the near term, at least, the model has shifted – challenging even the most agile supply chain. Billions of dollars of capital project deferrals have been announced in the last few months – driven by concerns around demand growth and in some cases to maintain liquidity in uncertain capital markets. There is also the potential for cancellation of future growth projects that looked certain only a few months earlier. Low natural gas prices and a new set of environmental regulations threaten large coal and nuclear construction projects in the development pipeline, while transmission projects appear to have greater support.

But the asset management challenges of aging utility infrastructure remain regardless of the economic climate. To paraphrase several utility executives at a recent supply chain conference – ‘most of the deferred projects cannot be considered discretionary. Costs may be deferred, but they will be required at some point.’ And regulatory expectations for service standards show no signs of accepting lower performance. [Potential reference to the current ice storm?]

The other wild card is evolving technology. Many states and the federal government are moving ahead with ‘smart grid’ investments and a wide range of distributed technologies. But the standards and policy will take time to complete, nor is there a guarantee of consistency or coherence on a national scale.

This market volatility, technological and policy uncertainty and increasing cost pressure make the supply chain function even more critical to the success of a utility. In order to help a utility meet these challenges, the concept of alliance partnerships has renewed relevance for all involved.

WHAT IS AN ALLIANCE PARTNERSHIP?

‘Alliance Partnerships’ are typically longer term (>2-3 year), mutually beneficial, trust based relationships based on mutual commitments and goals. In our discussion, these are between a Utility and its suppliers. The concept of alliance partnership is advanced in many industries, such as automobiles and electronics. While less developed in many aspects of the utility industry, the idea of partnership it represents has a strong resonance in the current market where utilities and their suppliers each face a world of uncertainty.

Alliance partnerships move a traditional transaction based supplier-utility relationship to a broader service based partnership. Most of the advanced supplier collaboration techniques such as EDI (Electronic Data Interchange), Collaborative Planning Forecasting and Replenishment (CPFR) and Vendor Managed Inventory are focused on optimizing inventory, lead times, and transactional processes. An alliance partnership adds another dimension to such a relationship, helping the two companies navigate supply, design, technology, and other issues that are not always transactional. Depending upon the category, the partnership could include providing quality systems, dedicated staff on-site, co-developing material standards, providing reliable storm responses, being part of the early

product design team, providing access to supplies from other accounts, or sharing marketplace trends. The supplier benefits by having established demand from the utility and significant access to its business. This gives the suppliers a competitive advantage that keeps growing over time. And in these markets, utilities are seen as more stable customers by both suppliers and their lenders.

Supplier selection traditionally falls under the scope of the Sourcing organization, whose other key charter is to drive cost effective procurement of materials and services. [This is often described as “getting materials where they need to be, when they need to be there, and the lowest total cost.”] This is typically realized through an annual ritual of supplier evaluations, competitive bids and negotiations, where each party tries to maximize its individual piece. Given the volatility of current markets, this time requirement alone can leave utilities exposed to wild fluctuations, or unable to take advantage of temporary opportunities. Alliance partnerships require a different approach – and if they work well, can realize significant value through identifying and capturing such events.

SUGGESTED FRAMEWORK FOR UTILITIES

Not all spend categories across Corporate, Generation, and Transmission & Distribution in the utility industry necessitate an alliance partner. Before investing in an alliance partnership, companies need to develop criteria to identify and prioritize categories. We suggest five areas for evaluation:

1. Supplier landscape consolidation: It is important to understand the competitive dynamic in the supplier landscape. Significant consolidation of suppliers includes areas such as material distributors, and line construction and maintenance. Understanding the leverage a supplier has in its marketplace, including its own economic strength, is an important factor in identifying the need for an alliance.
2. Parts standardization: Alliance partnerships are critical to categories where there is a need to standardize parts across industries. Standardized parts allow suppliers to achieve economies of scale which lead to lower costs across the supply chain. Advanced metering, automation and control are examples of categories undergoing significant change
3. Criticality of part/service: In the utility business, disruptions are more noticed than good service. Spend on suppliers for emergency response or customer facing services require considerations for partnerships. Generation is the area which typifies this need, but the same calculations should apply to distribution outages and a variety of other service areas.
4. Specialty skills: The aging workforce leads to a focus on partnering with contract labor sources. This is accentuated by new construction in areas such as generation and transmission, where there will not be a recurring need. However, the economic downturn does raise questions about the near term forecast for retirements, and projections for a continued shortage of specialized craft skills.
5. Macro-economic conditions: At any given time, certain macro-economic, regulatory or other factors that are utility or region specific enter into the evaluation of a category and/or partnership - such as union relationships, recovery from natural disasters, or financial concerns

The above factors are used in **Figure 1** to show examples of categories within T&D that would be candidates for an alliance partnership. Line construction and specialized material stand out as categories where alliance partnerships should be seriously considered. To further explain the factors, take the example of Line Construction. Here, suppliers were typically small independent local players. However, over the last 5-8 years, there had been noticeable consolidation: the top 3-4 companies spread nationally through acquisition and consolidation⁴. In addition, 60% of today's experienced utility workers, also needed by phone and cable companies, were projected to retire by 2010⁵. Knowledge of specific utility territories and lines, high equipment costs and other factors create additional barriers of entry for competition. All these factors lead utilities to consider an alliance partnership with line construction and maintenance providers. Typically, a large portion of spend could be done with a preferred vendor, with the rest through competitive bids to local vendors, as available.

SUCCESS FACTORS FOR ALLIANCE PARTNERSHIPS

Alliance relationships, while trust based, require the overall framework and expectations to be well understood and agreed upon by the two parties. Some key factors for success include:

1. A Paradigm Shift - Alliance partnerships require a shift from the 'You versus Us' to a more trust based relationship. Partnerships facilitate moving from 'lowest price' to a 'total life cycle cost' perspective. In a transactional environment, supplier strategies that do just enough to win the contract rarely deliver the greatest benefit. This is not a trivial change – particularly from processes, skills and cultural change required at the utility. Where there may be 'procurement' today, being an effective alliance partner requires materials, procurement, engineering and operations to work together, as well as partnering effectively with their peers at the supplier.
2. Sponsorship – Sponsors are needed to set the direction, help identify future challenges and success factors, ensure personnel commitment, consistency and periodically to review progress. As alliance partnerships can be wrongly characterized as non-competitive relationships with suppliers, it is important to have appropriate sponsorship.
3. Performance Evaluation – It is important to establish a baseline of key financial and performance metrics and identify and commit people dedicated to the relationship. A third party audit of the partnership or of the individual participants in the relationship is typical, and can also help in a regulatory context. Similarly, establishing frequency of meeting, plant visits, basic service levels and identifying areas of criticality are important components of the evaluation framework.
4. Contracting – Unlike a typical contract, this should be a flexible and evolving document. It needs to recognize that the benefits or value created by the partnership will be shared by the service provider under terms agreed to in advance. Contract terms should be flexible to allow changes as the business requirements and partnership evolves. This includes changes to scope, statements of work, specifications, SLA and pricing that minimizes risks to both parties and ensures sustained economic parity. For certain categories, it is important to benchmark and agree to an acceptable range of margins of the service provider. As cost to the supplier increases or decreases, so does the price, while the service provider still makes the same margins.

True benefits of an alliance partnership are gained by having mid to long term relationships (>2-3 years). It should also be a common understanding that an alliance partnership does not grant exclusivity to the supplier. In fact, it has to be common practice for the utility to check market pricing or conduct spot purchases for a sample basket every 6-12 months or as needed. Eventually when the contract nears expiration, the value that the alliance partner has delivered (savings, value added services, non-financial benefits, others) need to be well documented for both parties as these will be the foundation for negotiations with the incumbent or other suppliers.

5. Governance - It is important to ensure two layers of governance: operational (managing service delivery, financials, performance, & day-to-day relationship) and strategic (overall relationship objectives, managing change, cultural alignment, removing in barriers to success, etc.) There is a need to build formal governance and socialization structures into the contract so that they are foundational to the relationship.

EXAMPLES OF SUCCESSFUL ALLIANCES

Alliances for T&D Materials: Prior to forming an alliance for sourcing T&D materials, one of our utility clients typically awarded business to the lowest of 4-5 suppliers, having supply contracts with all of them. An alliance was formed with a large distributor after a detailed proposal process that included eight suppliers throughout the Midwest region.

In addition to the initial savings driven by better pricing, the client is currently realizing 4 - 5% annual savings⁶, driven by:

- Consignment of high dollar, high usage material
- Reduction & automation of transactions

- Dedicated, on-site representative to assist with shipments, standards technical assistance, etc.
- Supplier-led part standardization efforts involving 8 other customers
- Dedicated resources for emergency responses

In addition, during the last three storms, the alliance partner shared inventory from its other customers (from as far away as Mexico) to improve response and reduce electricity downtime for consumers. Purchasing does perform occasional spot buy analyses on non-contract electrical distribution materials to ensure that they are receiving the best price possible from the alliance partner, with whom costs have only risen 0.75% over the last 18 months⁶.

Alliances for Poles: With any heavy residential or industrial growth, reliability of supply is very volatile. In the case of poles, one of the largest national pole manufacturer and distributors has forged strong alliance partnerships with the top 20% of its utility and telecom customers, who represent 65% of its total committed obligations (the remaining business is driven by spot purchases). At times, when demand from alliance partners increases, the spot business is reduced or even completely shut off to meet alliance needs. The utilities benefit by being guaranteed supply of wooden poles, while the supplier manages and mitigates its demand fluctuations.

CONCLUSIONS

The concept of Alliance Partnerships is not new, but the volatile and challenging environment makes it an increasingly relevant pathway for utility supply chain operations. While it is sometimes incorrectly characterized, or with ineffective structure or management it can result in a non-competitive relationship between a supplier and utility, it is a strategy that should be seriously considered given the challenges ahead. In order for alliance partnerships to be successful, utilities need to define a framework that clearly differentiates them from traditional suppliers and supply agreements. The framework should include approaches to identify the categories, a partner selection process, and a flexible and distinctive contracting process that can be tailored for each partner. The utility also needs to provide and support the right cross-functional teams and sponsorship, while suppliers do the same. In the good old days of last year, this was a strategy for improved performance. In this environment, it is an even more critical component of survival.

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RELEVANT FIGURES AND CHARTS

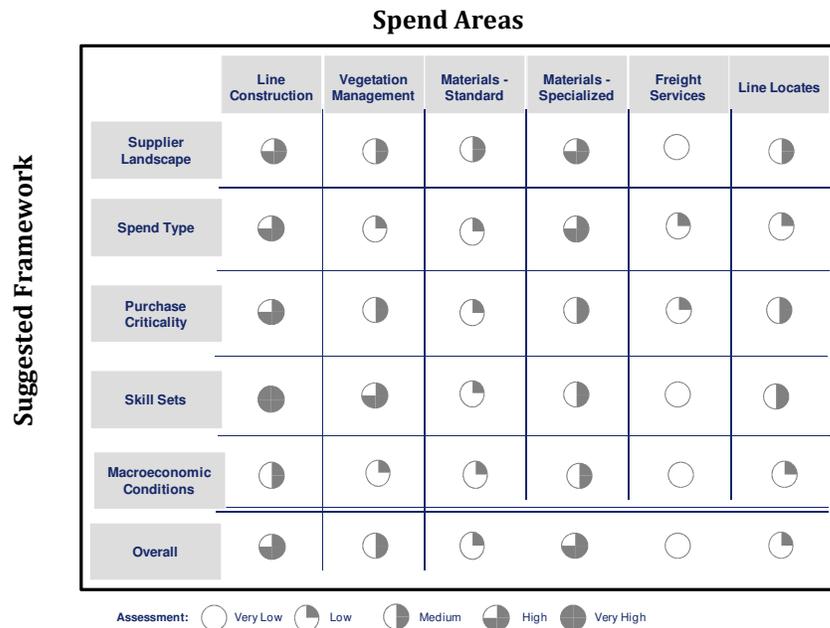
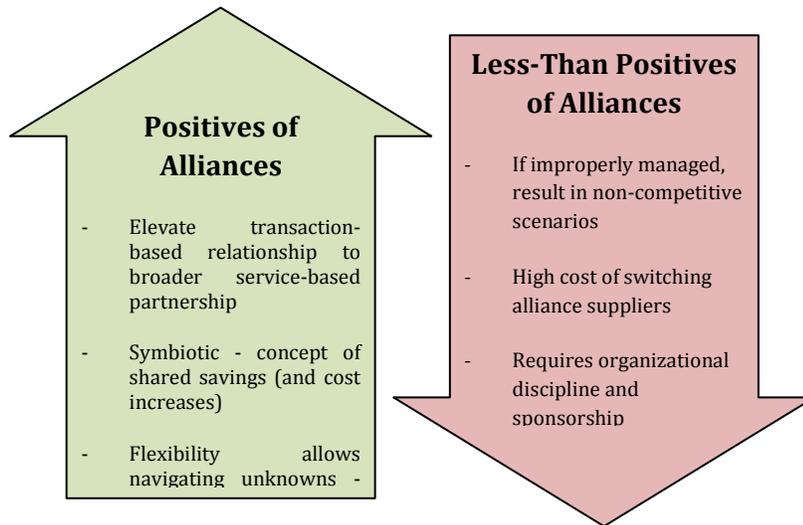


Figure 1: T&D Category Prioritization for Alliance
(Source: Bridge Strategy Group)



Alliance Pros & Cons

AUTHORS



Parvez Patel is a Management Consultant at Bridge Strategy Group LLC. ppatel@bridgestrategy.com



Robert Zabors is a Director and leader of the Energy Practice at Bridge Strategy Group LLC. rzabors@bridgestrategy.com

CONTRIBUTORS

Tushar Narsana, a Management Consultant at Bridge Strategy Group contributed to this work. tnarsana@bridgestrategy.com