

Top of the Commodity Cycle or Structural Shift for Sourcing?

Managing utility sourcing programs through a period of upward price volatility

Sourcing strategies have returned as a critical issue for energy utilities. External pressures on the supply base are raising new risks and fewer opportunities, and utilities that lack a truly strategic approach to sourcing will likely be surprised.

A unique set of cyclical price pressures in raw materials and labor markets is causing upward price volatility. If mishandled, these pressures might transform today's cost savings programs into tomorrow's cost avoidance programs. This *Perspective* discusses a strategic sourcing approach that can anticipate these developments while continuing to deliver major improvements the bottom line.

Cost-saving efforts today have a defensive quality, as rising fuel prices for utilities in all regions of the U.S. have put upward pressure on customer rates. Faced with intense legislative, regulatory, and consumer scrutiny, utilities hope that cost-cutting will protect their earnings outlook. Unfortunately, many components of rising costs lie outside utilities' direct control, notably including:

- Input fuels and purchased power
- Required power plant environmental investments
- Transmission capacity investments
- Employee health and welfare coverage and pensions
- Security and insurance premiums
- Raw materials (e.g., copper, steel) impacting purchased goods
- Emerging labor shortages impacting supplemental labor costs
- Regulatory compliance (e.g., Sarbanes-Oxley)

While the situation varies from one utility to the next, widespread cost escalation in raw materials and labor markets (Exhibit 1) means the industry needs to more carefully manage interactions with the supply base.

Exhibit 1 Key components driving utility cost increases

Supply base cost inputs	Illustrative components	Representative escalation	
		Period March 2000-Sept. 2005	CAGR
Input fuels	<ul style="list-style-type: none"> • Crude oil • Natural gas 	228%	16%
		197%	13%
Raw materials	<ul style="list-style-type: none"> • Copper • Steel • Industry chemicals 	215%	15%
		49%	8%
		56%	8.4%
Direct labor	<ul style="list-style-type: none"> • Labor cost index, wages and salaries 	117%	2.9%
Indirect labor	<ul style="list-style-type: none"> • Labor cost index, white collar wages and salaries 	118%	3.1%
Employee benefits	<ul style="list-style-type: none"> • Labor cost index 	135%	5.6%
Insurance and security	<ul style="list-style-type: none"> • Risk premiums • Security costs 	N/A	10-15%

Source: Bureau of Labor Statistics, Commodity Research Bureau, Yahoo Finance, Oliver Wyman analyses

The Appeal of Sourcing Strategies

An old cost-savings favorite, sourcing strategies, is back in vogue. Strategic sourcing has been practiced by utilities since the mid-1980s, and many have returned to this work with a vengeance. Cost take-out from the supply base holds appeal on several dimensions:

- Represents a significant component of utilities' cost structure and offers real bottom-line impact
- Spares upheavals and the loss of morale associated with eliminating employees (especially given complexities tied to an aging workforce)
- Benefits from widespread board support, since many directors have used supply chain initiatives in their own companies
- Constitutes significant synergy savings in horizontal mergers between utilities with overlapping supply bases

The traditional expectation for savings from addressable spend is 3-6% for commoditized hard goods (e.g., cable, conductor, meters, and distribution transformers) and 5-10% for services (transmission and distribution (T&D) line contractors, information systems contractors, and power plant supplemental labor forces). However, in the face of manufacturing capacity shortages, lower craft productivity, and labor shortages tied to an aging workforce, many observers now project these costs will increase. For utilities spending billions of dollars on goods and services as part of an infrastructure boom, these estimates translate into tens of millions of dollars of potential savings at risk.

Many sourcing efforts start with detailed spend summaries and a short list of spend categories and sourcing strategies for a one- or two-year forecast period. Our experience suggests that this traditional approach falls well short of anticipating today's dynamic supply markets. The lack of a truly strategic approach to sourcing stems from several tendencies:

- Lack of a big-picture view
- Prevalence of backward-looking, static tactics
- An inward focus that misses developments in core supply markets
- An ineffective overlay of sourcing strategies onto asset management programs

Separately, each of these influences will limit results. Together, they dramatically undermine the potential for cost containment while increasing the risk for cost escalation. Let's look at each in turn.

Understand the Big Picture

Strategic efforts, by design, need to consider a broad landscape in order to put sourcing initiatives in the context of value creation. Oliver Wyman routinely captures this view through intensive benchmarking of performance by individual purchase category and across the entire supply chain.

Findings from these benchmarking efforts have led to several strategic insights. On the quantitative side, examples include:

- Significant gaps in spend benchmarks suggest large potential savings when total purchases of goods and services are normalized per customer (for distribution) or per megawatt hour of production (for generation).
- These benchmarks point to 20-40% cost reductions per category for under-performing utilities, far better than the 5-10% reductions suggested by generally accepted practice.
- For many of utilities, these figures represent tens of millions of dollars in untapped savings potential.

Findings on the qualitative side reveal emerging trends that underpin the nature of

future spend. For example, in the distribution sector:

- Self-diagnosing distribution grids are on the drawing board, consistent with widespread deployment of two-way communication technologies.
- Line crews will work predominantly in a live-line environment, with repair crews expected to master new skills.
- Distribution circuits should perform much closer to design margins than previously.

Each of these trends has the potential to change the nature of a utility's relationships with its suppliers. Informed sourcing strategies will monitor and anticipate shifts to the operating environment.

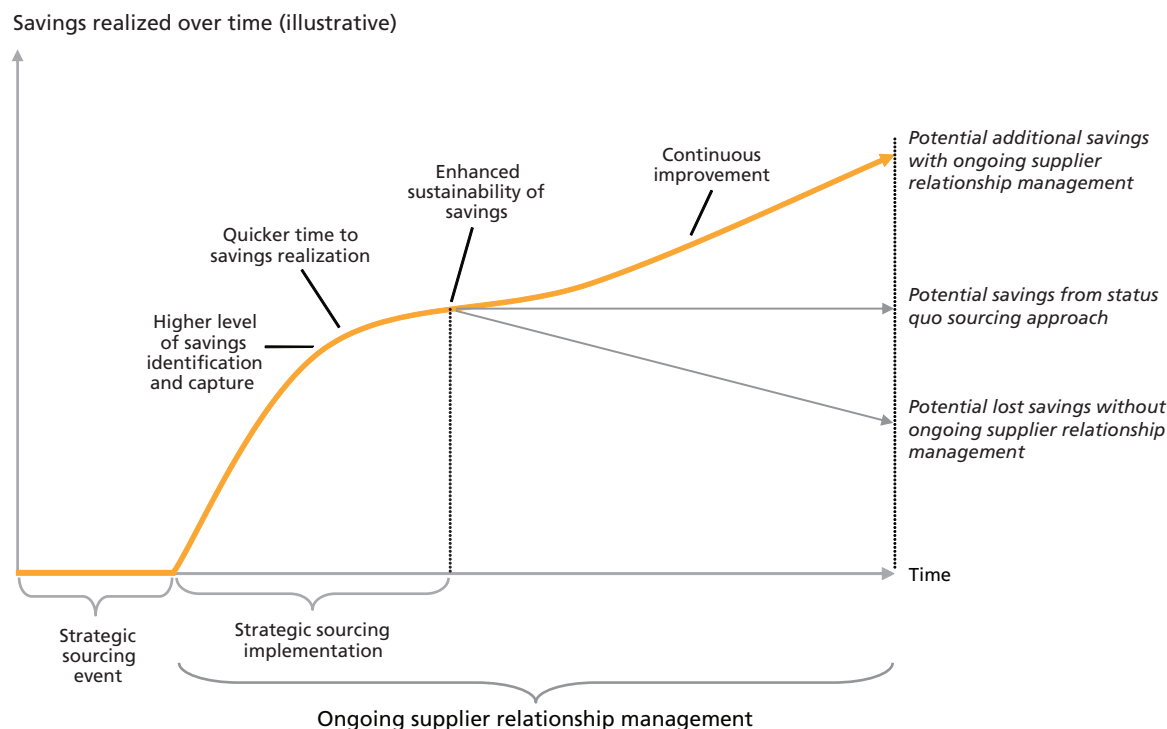
Take a Forward-Looking Approach

Strategic thinking pays close attention to future positioning and needs. Yet most strategic sourcing work is inherently backward-looking. It uses spend trees built with historical data to target savings, while forecasts of future needs and related spend on goods and services tend to be missing or inaccurate. Managers spend little time integrating forward-looking asset management strategies with strategic relationships in the supply base, such as the need for high-voltage line contractors in transmission build-outs. Moreover, strategic contributions from the supply base are rarely called out as a vital part of a utility's business design.

The net effect for most strategic sourcing efforts is a one-time contribution of cost savings, rather than a continual alignment of supply base relationships with asset investment programs. Supplier relations tend to focus instead on consolidating volumes and reducing prices, which hinders efforts to build longer-term partnerships.

As the industry increasingly needs to rebuild, reinforce, and expand infrastructure across the power sector value chain, a static view becomes especially limited; forward-

Exhibit 2 With suppliers, take the long view



looking supplier partnerships will become a key lever for sustainable value creation (Exhibit 2).

Cultivate an External Perspective

Sourcing work, by definition, requires an external focus and attention to emerging supply market developments that does not lend itself to internal discussions of planning criteria and annual budget reviews. Procurement teams often focus on providing superior service to “internal customers” and dwell on internal demand signals for goods and services. They lose sight of the depth and severity of changes occurring in core supply markets and fail to advise operating units of critical developments. The recent run-up in power transformer prices is a classic example (Exhibit 3).

For years, transformer manufacturers have experienced a wave of consolidation, removed excess capacity, moved their operations off-shore, and experienced dramatic run-ups in commodity metals prices. Clearly experiencing an upward price cycle over the past several years, shrewd procurement

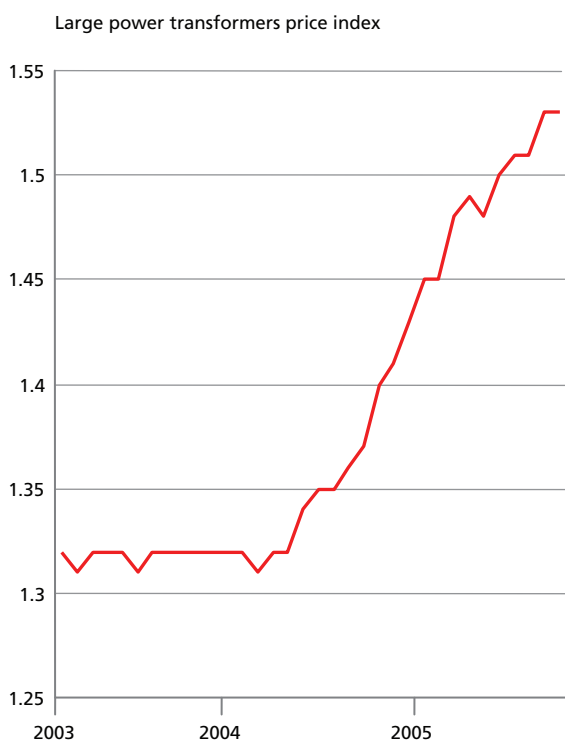
teams were refreshing their sourcing strategies and locking in volumes and price points two to three years ago. Those not anticipating these types of supply market shocks are being relegated to “price takers.”

Another wave of rising prices is now occurring in craft labor markets serving the power sector, where more workers are retiring just as the power sector build-out hits its stride. Conversely, service contracts with application software providers offer significant savings potential as they strive to link services with software to avoid commoditization of their product lines.

Integrate Asset Management and Sourcing Strategies

In many instances, senior supply chain executives are not intimately involved with the asset management strategy and asset investment plans are not tied into the evolving dynamics in supply markets. Furthermore, asset strategies tend to be more akin to spending programs than asset investment plans. The lack of clarity around asset investment plans can undermine supply

Exhibit 3 Power transformer prices accelerate



Raw materials price increases change year over year		
	2004	2005
• Aluminum	19.9%	10.6%
• Copper	60.9%	28.4%
• Transformer oil	30%	N/A
• Steel	49.3%	-3.6%

Source: Bureau of Labor Statistics, Commodity Research Bureau, Yahoo Finance, Oliver Wyman analyses

chain management’s ability to make a substantial contribution. Factors such as the timing of large purchases, current supply market conditions, or the availability of supplemental laborers do not inform key trade-offs within asset management strategies.

As a result, sourcing strategies often fall out of step with core market conditions and utilities use procurement models that are aligned with past supply environments, which featured commodity and service excess capacity. Practices that maximized value in this environment, such as spot bidding, will not work well today when capacity shortages are looming. The inability to access certain construction services skills is already starting to effect the timing, duration, and cost of major projects.

Put Strategic Thinking Back into Sourcing Work

An early emphasis on the strategy of a utility and how asset plans intersects with vital supply markets allows managers to achieve significantly greater operating and financial results. Oliver Wyman backs this

notion with robust benchmarking databases that clarify the size of the opportunity for cost take-out (Exhibit 4).

Seven principles can help guide the effort:

1. **Define scope strategically.** Choose purchase categories consistent with your asset management strategies (e.g., in support of environmental retrofits or transmission build-outs) and adopt practices that start with internal customer priorities and use benchmarks to size the opportunity.
2. **Employ joint teams.** Use multi-function teams and involve suppliers to promote innovation and buy-in.
3. **Collaborate with suppliers.** Share information in a meaningful way and choose partners based on their track record for driving change within utilities.
4. **Use targeted, objective goals.** Focus on a short list of purchase categories with explicit targets for cost take-out. Avoid

Exhibit 4 Is the current response sufficient to meet future challenges?



long lists of tactical categories, vague sourcing strategies not tied to the market, or broad ranges of estimated savings.

Offer line units innovative ways to contain their escalating budgets and show them the value in supply base initiatives.

5. **Stick with the tried and true.** Since many companies source office supplies, wireless telecommunications, legal services, and servers, tap into known best practices by purchase category and extract value from tried and true methods.

7. **Create governance models with “teeth.”** Establish business-unit led procurement councils that drive sourcing efforts, infuse teams with courage to challenge the status quo, and track progress. Strong councils fuel multi-year success.

6. **Bake targets into budgets.** Become part of the solution for lines of business like T&D operations and the nuclear fleet.

These principles, backed by rigorous analysis and solid data, will put the strategic thinking back into strategic sourcing.❖

Oliver Wyman

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