

Asset Management – a natural sequel to e-procurement?

Collaborative procurement can reduce costs – but third party Asset Management can lead to far greater efficiencies. Thomas Yeung examines the concept and potential implications.

Introduction and context

Utilities in the UK are under intense pressure to reduce costs. In the water sector, the latest regulatory review has forced companies to consider seriously whether they want to remain in that industry, and several companies (Kelda, Glas Cymru, United Utilities, to name but a few) are openly experimenting with changes in corporate structure and ownership in an effort to reduce their cost of debt. In the electricity sector, utilities have already achieved much of what was available in terms of simple efficiency gains, and are now looking at outsourcing more of what have previously been considered core activities. And across industry sectors, utilities are working together as never before, looking for best practice and combining their procurement activities through (internet-based) organisations such as selectusonline, Achilles, Eutilia, and Pantellos.

We believe that joint procurement through an efficient channel can lead to savings of perhaps 5% – 10% on current O&M expenditure. While useful, we consider that this approach fails to realise a far more significant source of value – that of introducing best practice in system design and planning, standardising O&M processes and equipment / materials, and reducing the number of suppliers to a small number of strategic partners. But utilities have been trying to agree standards for years, with limited success – what do we think is different now?

One way of achieving a common approach to Asset Management would be for a number of utilities to outsource Asset Management to a single dedicated organisation. That way, they could share (perhaps through lower O&M costs) some of the benefits of joint asset management, meet their regulatory targets, and still retain the asset and associated customers. This Asset Management company could be a JV formed by the utilities themselves, or a new entrant.

Asset Management is big business: we estimate that the annual UK spend on distribution network infrastructure (electricity, gas, water, rail) is over £15 billion, and any organisation that was able to secure a significant part of this expenditure would be well placed for success: it would wield enormous buying power and so could extract advantageous prices from its suppliers and sub-contractors, and its lower cost base would enable it to undercut any competition from conventional utilities.

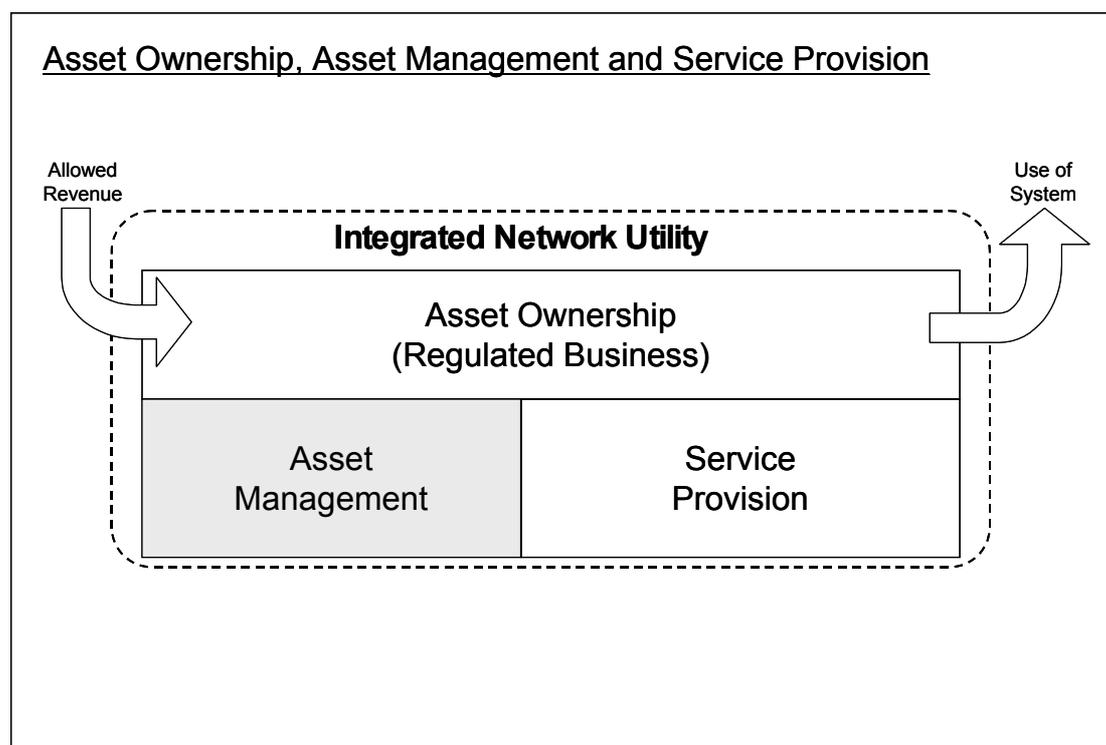
Several utilities have explicitly stated that they intend to focus on Asset Management: these include 24seven (which services the electricity assets of London and Eastern), United Utilities (which looks after Norweb's electricity network, North West Water's water assets, and now Glas Cymru's water assets), Severn Trent, Suez, Vivendi, and others. Outside the utilities, several of the larger engineering firms such as Bechtel,

Skanska, Jarvis, WS Atkins and others consider that they are already in Asset Management: they share risk with clients through DBO (design, build operate) and full-life O&M contracts as well as fee-for-service contracts.

And yet, despite the best efforts of groups like UU and 24seven, few Asset Management contracts have been awarded to date. Why? What is Asset Management, and how does it fit into the conventional utility model?

A new three part business model

A conventional integrated network utility can be considered as follows:



While historically each of these three activities has been done in-house, we consider that the skills required are so different that no single integrated utility can achieve best practice in all three areas. Thus value can be created by splitting the integrated utility into three separate entities, each focused solely upon a single activity.

Each of the new businesses will have a single well-defined focus, and can structure and fund itself accordingly. While initially the Asset Manager and Service Provider have contracts with the original Asset Manager, we expect them to compete for new business outside the parent company, and eventually to stand or fall on their own merits.

Each of these three activities is described in more detail below.

Asset Ownership

In this model, the Asset Owner owns the network assets and is the licensee. It negotiates an allowed revenue with the regulator, based upon benchmarked operating costs and a 'reasonable' return on the asset base. It is responsible for ensuring that the licensed activities are delivered to the satisfaction of the regulator for the benefit of the consumer.

At a recent conference, Steve Bentley of Severn Trent Water succinctly described a seven stage evolution of Asset Ownership:

- Stage 1: The organisation has engineering and operational departments but the concept of 'asset ownership' is unknown
- Stage 2: The search for value for money begins with the recognition of investment appraisal as a business function. The owner of the assets is not defined
- Stage 3: The role of Asset Owner is formally recognised in the organisation and influences the need for and shape of investment
- Stage 4: Engineering, now seen as a service that can be bought in, is outsourced
- Stage 5: Recognising the close links between them, the roles of asset planning, operation and maintenance are brought together to form a single asset management function
- Stage 6: In the search for lower cost, operation too is outsourced and the organisation focuses on asset ownership
- Stage 7: Asset Ownership remains as the sole focus of the utility, with both engineering and operation let as a single function to a separate company

In his model, the answer to the question 'What is the utility of the future?' is clear: a utility is the regulated entity that holds the licence and owns the regulated assets.

In principle, the Asset Owner requires little or no previous experience of the industry, because it contracts out all operations, maintenance and management of the asset to others. In this case, Asset Ownership becomes a low risk activity, and in the long term we expect Asset Owners to include financial institutions that treat owning a physical asset as an alternative to owning a paper bond.

Asset Management

The Asset Manager is an unregulated entity that decides how best to manage and develop the regulated asset in order to meet current and projected requirements. In a conventional utility this would include System Planning, Network Design, Capital Projects teams etc.

Asset Management requires a deep understanding of the industry and the regulatory environment. However, it does not require in-house capabilities in each target sector, because it can draw upon its portfolio of service providers to provide specific hands-on capabilities as necessary. Thus an Asset Manager could, in principle, serve Asset Owners in more than one sector (gas, water, electricity) and need not be geographically close to the network being managed.

Service Provision

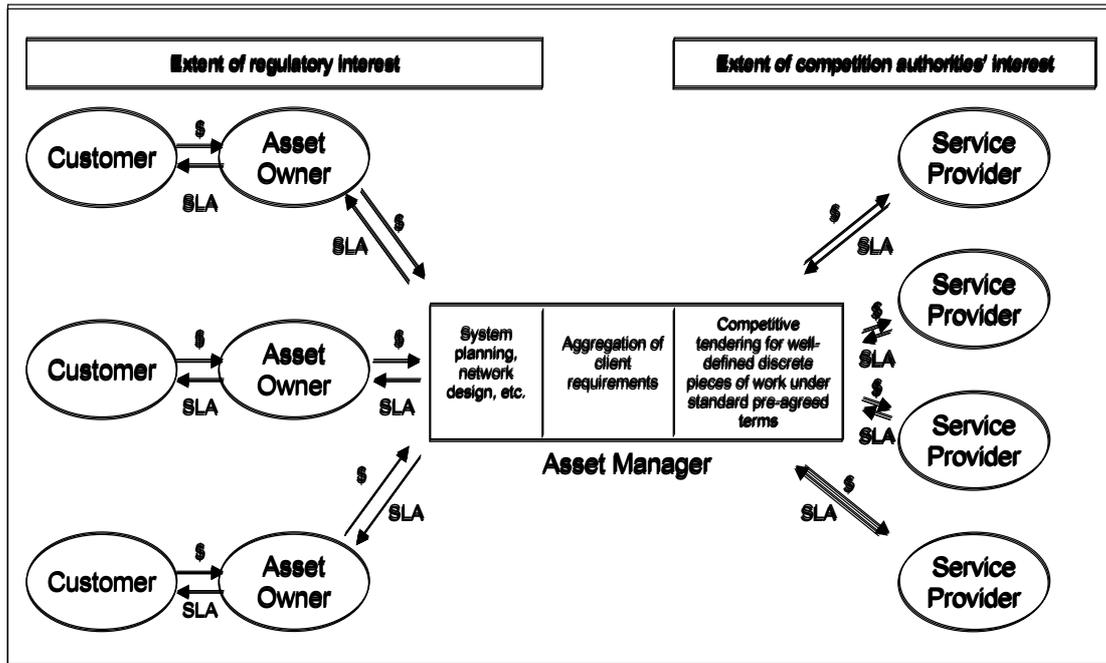
The Service Provider(s) are the businesses that operate and maintain assets on a day to day basis: we include in this category the operations and maintenance staff of the original integrated business, plus any third party(ies) that may be contracted to provide defined services to the Asset Manager on a Service Level Agreement ('SLA') basis. Depending upon the size and complexity of the contracts put in place, Service Providers can be individual companies or consortia of companies created specifically in response to particular contracts.

Long term, we expect an Asset Manager to develop a portfolio of Service Providers, which will include organisations with engineering (Civil, Mechanical, Electrical) capabilities, equipment manufacturers, operational staff in each target industry (perhaps drawn from the client organisations), designers, project managers, etc. There will always be some overlap of skills between the Asset Manager and the Service Provider, but the key distinction is that Service Providers can serve multiple Asset Managers, whereas any regulated asset has only one Asset Manager.

Regulatory and Competition Implications

The existence of 24seven and the recent Glas Cymru deal suggests that regulators can become comfortable with the concept of separating ownership from operations and maintenance. However, regulators will want to be confident that the contractual arrangements set in place by the Asset Owner (the licensee) will be adequate to ensure continued delivery of the licensed activities, and that appropriate mechanisms are in place such that the Asset Owner retains 'control' of the Asset Manager, particularly if things go wrong. So while in principle both Ofwat and Ofgem consider that their sole relationship is with the Asset Owner as licensee, we consider that they are likely to want to review and become comfortable with the contractual arrangements between Asset Owner and Asset Manager.

Regulators will also want to see that the licensee's costs are reasonable: they will want to review the fee paid by the Asset Owner to the Asset Manager, and to benchmark this against alternatives including keeping everything in-house. However, if as expected, there are cost reductions available from aggregating demand from multiple assets, outsourcing to a specialist Asset Manager (with supporting Service Provider(s)) should be more cost effective than doing everything in house.



Competition authorities will want to be confident that a competitive market exists for service provision. This is in the Asset Manager's interest too, and we expect that a successful Asset Manager will have best-practice processes in place for encouraging full and fair competition among prospective Service Providers.

However, competition issues may arise as an Asset Manager becomes more successful. Evidence from other industries (such as automotive and telecoms) shows that organisations that transfer responsibilities to third parties tend to develop a small number of quite large suppliers. They also tend to let larger and longer contracts to the Service Providers, giving them more scope for innovation and investing in efficiency improvements. As a result, we expect some increased consolidation downstream of the Asset Manager.

Criteria for success

In principle, an Asset Manager can stand on its own as a competitive business serving multiple networks across industry sectors. Many of the skills required (such as project planning, contractor management, engineering design, regulatory etc.) and activities (network design, system planning, maintenance and refurbishment strategy, etc.) are core competencies for an organisation with a background in a conventional utility.

However, no true Asset Management contracts have been awarded to date: 24seven has yet to win a major utility contract from anyone other than its parent companies, and the recent contract awarded by Glas Cymru severely limits the scope that UU have for changing investigating opex/capex trade-offs, etc. The contract is more outsourced operations and routine maintenance than true Asset Management.

Why? We consider that the reasons why Asset Owners do not allow third party Asset Managers to take on responsibility for managing their asset can be summarised in just two words: Credibility and liquidity.

Credibility

Asset Owners tend to view the regulated asset as their ‘crown jewels’, and quite understandably want to be confident that they will be maintained properly. Further, as licensees the Asset Owners are responsible for ensuring that all licensed activities can be carried out, and so are wary of relying on organisations without a strong track record of looking after such assets. In particular, Asset Owners from one industry (water, gas, electricity) typically want their prospective Asset Managers to be able to demonstrate experience in that particular industry. This is one reason why we believe that Asset Managers will probably combine the expertise of two or more former utilities from different industries, and that successful Asset Management organisations will be cross- industry.

Liquidity

Even if an Asset Manager were to develop credibility in all target industries, it may still find it difficult to persuade Asset Owners to relinquish control of their assets. This may be a function of regulatory concerns, stakeholder pressure, incumbent arrogance, or some other reason. Whatever the cause, this lack of liquidity in the market needs to be overcome if third-party Asset Management is to become a reality.

Implications of this new business model

Disaggregating integrated utilities is likely to have major implications for the industry, its customers and suppliers. These are addressed in more detail below.

For Asset Owners

In principle, Asset Owners may be able to achieve reductions in operating cost through:

- Shared best practice in design, operations, and maintenance strategy
- Access to a wider range of carefully selected service providers
- Economies of scale in delivered services and materials

The extent to which Asset Owners can capture these benefits for their regulated customer base will depend upon their negotiating strength vis a vis the Asset Manager, and on how much of the potential benefits the Regulator requires should accrue to the consumer.

Over the longer term, and through the periodic price reviews, we expect the industry to converge towards a three part business model. Benchmark competition will force all licensees to match the benchmark costs achieved by an effective Asset Manager/Service Providers team, and so integrated utilities will be forced to change their approach.

For regulators and customers

Regulators have tended to use benchmark regulation to encourage greater efficiency in the provision of monopoly services. While over the past ten years this has been effective in driving down costs, it has not managed to encourage best practice in

design and planning. In particular, while industry committees have attempted to agree standards in many areas of activity, they have tended to be made up of engineers, and so have focused more upon technical performance rather than economic efficiency.

We consider that a third party Asset Manager has all the right incentives to look for ways in which it can simplify its procurement and total purchasing costs – it will look for ways to reduce the number of separate lines that need to be stocked and the complexity of installation. For example, an independent Asset Manager will examine carefully its requirements for, say, paint, and trade off specification, cost, storage and handling costs, ease of use, and lifetime across a number of different areas, and will attempt to choose the best (small) combination of products from a (limited number) of paint suppliers. Whereas in the past an electricity company may have specified a specific paint in battleship grey to protect their transformers, and a water company may have specified a different paint (in yellow) to protect its pumps and valves, an Asset Manager may find it better to use a single paint (possibly in two different colours) from a single supplier to do both jobs.

For suppliers to the industry

If the Asset Manager's requirements are large, then suppliers will be keen to win that business. By aggregating and simplifying requirements and building a strategic relationship with a limited number of suppliers, the suppliers' production runs can be lengthened and optimised, leading to lower delivered costs. As always, the potential saving associated with a longer contract has to be set against the loss of competition benefits of multiple short-term auctions.

From our experience in sourcing goods and services in a number of industries, we believe that the optimal position will be multi-year contracts with a small number of selected suppliers, who will be encouraged to size accordingly and share benefits with the buyer. As the size and complexity of each category increases, we would expect suppliers to consolidate or form strategic alliances in order to win these larger contracts, and to be better positioned to share risks among themselves and with the buyer (Asset Manager).

In the long term we consider that the evolution of specialist Asset Managers will facilitate consolidation of Service Providers that focus upon volume activities (e.g. civil engineering, turnkey projects, etc.), while enabling a small number of specialist service providers (such as transformer makers, specialist cable manufacturer, etc.) to thrive if their particular product/service becomes the new standard. Disaggregation and increased focus speeds up evolution of all three markets.

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