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Finding Cash In the Utility Supply Chain



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EXECUTIVE SUMMARY

Many utilities are scrambling to find ways to preserve cash. The dual blows of demand slowdown and the credit crunch make having cash on hand an essential component of doing business. Utility supply chain management (SCM) executives need to actively seek out ways to preserve cash in SCM-related activities.

The good news is that there are a number of cash-preservation ideas that utility SCM executives can implement. By engaging the chief financial officer and the executive team for support and cross-functional resources, as well as applying active review of current and planned expenditures and programs, utility companies can find and free cash in various areas of the supply chain.

KEEPING CASH ON HAND

The fastest way to preserve SCM-related cash is to stop buying. It may seem like an obvious step, but many companies do not change their spending patterns until internal operating and capital budgets are scaled back or until the company is pressured by regulators to do so. Of course, utility companies that stop buying can't shut down purchasing activity completely. Instead, most can benefit from an aggressive, comprehensive review of major dollars spent on open orders, as well as expenditures committed in the contracting and requisitioning queue. Many of these orders and requests were likely generated before the economic shift and represent future work that is being deferred or cut from budgets.

By sorting outstanding orders and requisitions from largest to

smallest, the SCM management team can discuss with budget owners opportunities to cancel or defer requirements. Suppliers and contractors may balk at canceled orders, but they understand current economic challenges and many are willing to make significant short-term concessions for long-term stability. The right approach to open-order rationalization will give the SCM team an opportunity to unwind canceled orders in the supplier base without unduly harming those relationships.

To avoid unnecessary work and potential order cancellations, the SCM team also needs to challenge planned capital and operations and maintenance (O&M) projects that are near the contracting or ordering stage. The business unit and functional budget-holders (e.g., information

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technology) are likely revisiting their plans and should be ready to discuss projects that may be canceled, deferred, or changed in scope.

Inventory is another area of immediate cash conservation, as well as an opportunity to cancel or delay open orders to avoid future cash leakage. For example, one utility re-examined its transmission and distribution (T&D) inventory and realized that a number of transformers were stockpiled in one region for a major reliability project that was delayed. The company redeployed these transformers to other regions, enabling cancellation of open orders and requisitions, saving the utility a major cash outlay.

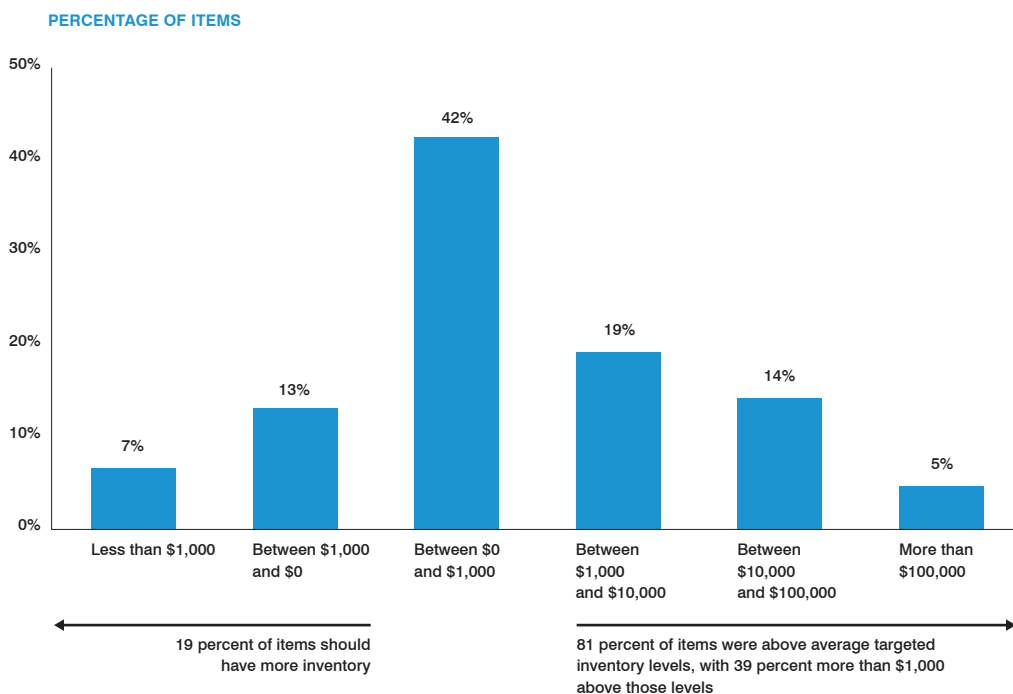
This is also a good time to reexamine overall inventory levels. Over the last few years, most utilities have been scrambling to ensure that material was available to support an increasing workload. The aftermath of storms and an overall increase in demand were taxing suppliers' ability to deliver sufficient quantities of many basics such as transformers, leading to concerns about supply security. As a result, many utilities increased inventory levels, absorbing cash in the process. As overall demand drops and supply concerns have eased, there may be more inventory on hand than needed. One utility recently analyzed its inventory to determine where it could be reduced and found that 80 percent of items were overstocked

relative to its targets (*see Exhibit 1*). Even after adding inventory dollars to restock needed items, this represented a significant opportunity for net inventory reduction and cost savings.

Changing inventory targets quickly reveal which supplies are available for redeployment, thus supporting the cancellation of open orders and requisitions. Additionally, it reduces future reordering volume, which will minimize future material cash outlays.

Accounts payable terms and processes are another potential source of near-term cash. This does not mean utilities should abuse suppliers by arbitrarily delaying payments. Rather, they should seek out cash-saving

Exhibit 1
Example of Inventory Analysis



Source: Booz & Company

opportunities. For example, most utilities have agreements with a portion of their suppliers that either allow the utility to pay quickly in return for a specified cash discount (i.e., 2 percent when the invoice is paid in 10 days) or to pay the full amount in 30 days. Simply shifting these suppliers from quick to normal pay can quickly make cash available, although the impact on the income statement has to be assessed.

Changing the payables process may also free cash without changing payment terms. For example, some utilities use a periodic process to pay suppliers (e.g., payments generated once each week), which often results in some suppliers getting paid earlier

than necessary based on agreed payment terms. By revisiting these processes, there may be ways to stretch payables within the bounds of current and accepted terms.

Of course, the utility may also decide to renegotiate or mandate payment terms to improve its cash position, but that is not an effective approach to maintain good standing with suppliers. Shifting payment terms may cause undue strain on a weakened supply base, and some smaller suppliers may not be able to weather longer payment cycles.

Possibly the most significant way to reduce procurement costs for materials and services is to rethink

spend category strategies. In the 1990s and early 2000s, many utilities had strategic sourcing or category management programs. In these initiatives, cross-functional teams conducted a set of analyses and recommended strategies for spend categories, such as transformers, construction services, and the like. Most of these efforts were thorough, with the team examining factors such as supply-market dynamics, total lifecycle costs, and others, then making a broad set of recommendations, ranging from changing specifications to switching suppliers.

In recent years, however, changes in the supply market have made these

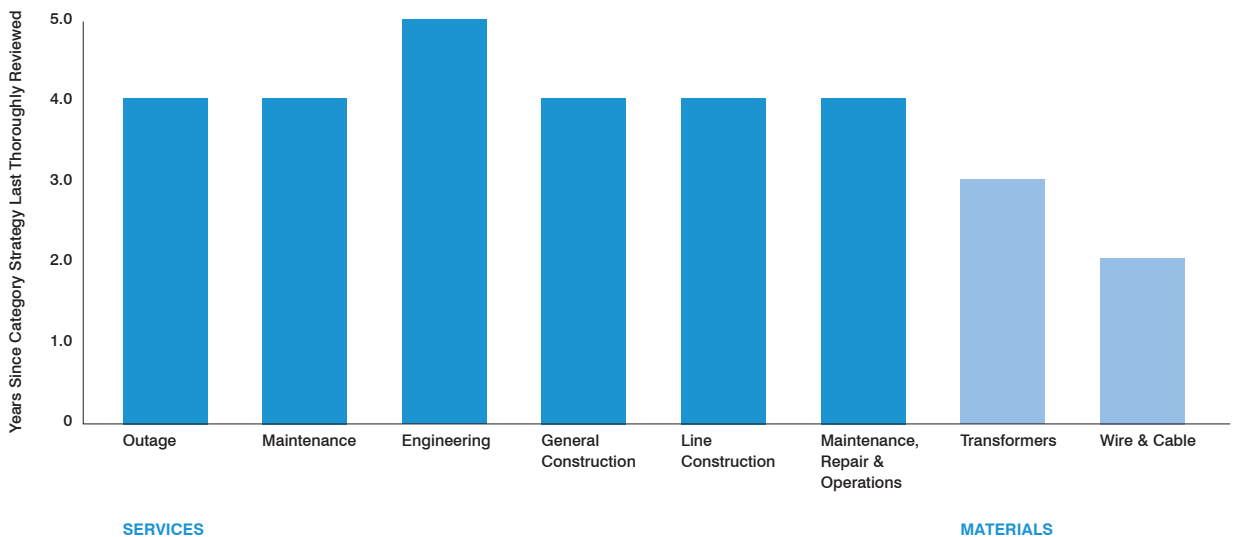
strategies stale. At the same time, the workload increase in utility companies' supply chain and other functions has made it difficult to find time to refresh these strategies. At one company, many of these strategies had not been revisited over the past three to five years (see Exhibit 2). Given the significant market changes that have occurred during that time, companies that have not reevaluated

these areas may be missing significant cash-saving opportunities.

The challenge of maintaining and updating these robust strategies for each category of spending has contributed to the rapid increase in the prices utilities pay for materials and services. In many cases, suppliers have been passing along major increases in their cost of business due

to price pressures on commodities such as steel. However, overall price increases may not have reflected the true underlying costs across the supply chain. As some price pressures subside, there is an opportunity to reevaluate and renegotiate category strategies and pricing arrangements with an eye toward different arrangements—for example, fair-return pricing.

Exhibit 2
Many Category Strategies Have Languished for Years



Source: Aera category profiles; Booz & Company

In a fair-return pricing arrangement, the buyer agrees to pay the supplier a price tied to the underlying fundamental costs of materials or services rather than perceived supply and demand balances. This generally means that the supplier will make more in a downturn but less in an up-cycle. However, this structure also provides suppliers with more consistent income streams. Similarly,

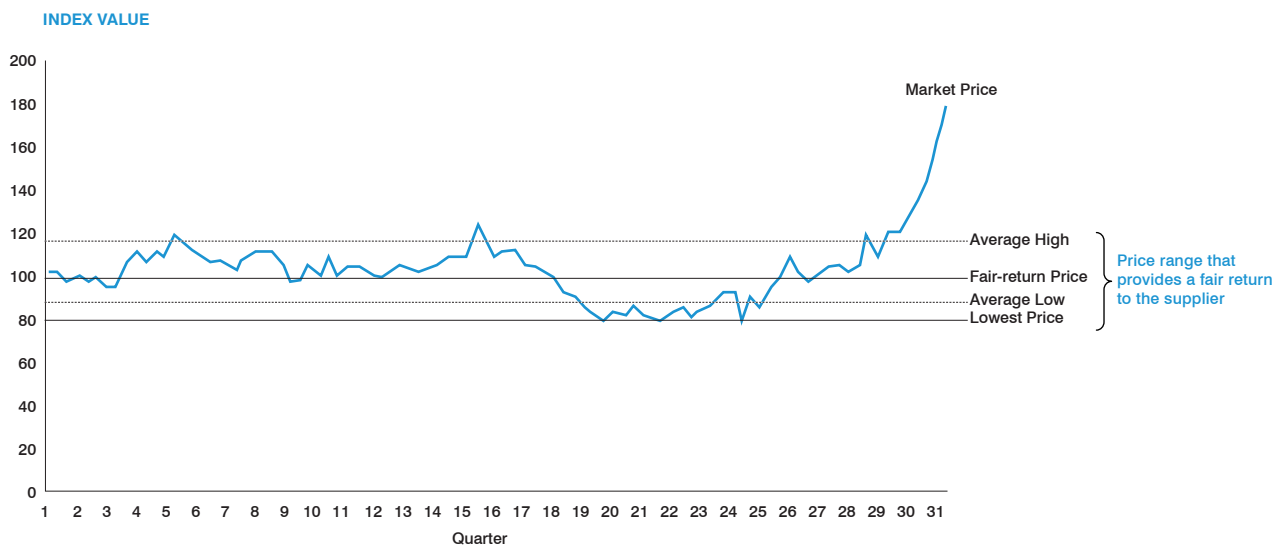
the buyer may appear to pay a bit more during the down-cycle, but generally will pay much less in the up-cycle, particularly when there are price spikes in the market (see Exhibit 3).

Suppliers are now much more open to discussions about alternative strategies and pricing structures as their businesses are challenged by the

downturn. However, utilities have to be prepared for these discussions to structure a true fair-pricing arrangement. To do so, the SCM team must understand the total cost and dynamics of the supply chain (see Exhibit 4).

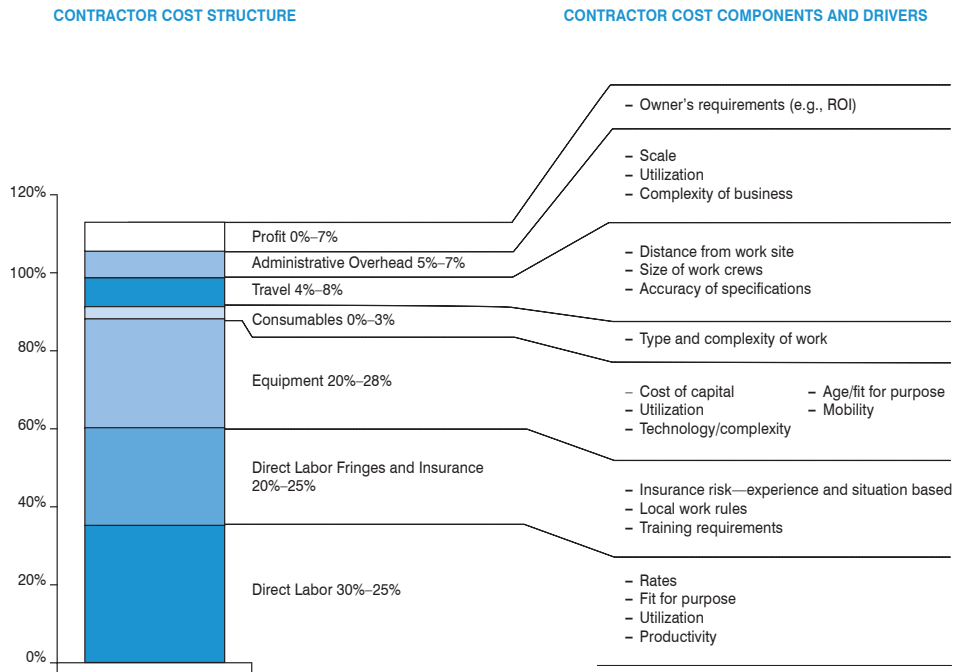
By understanding these costs and dynamics, supply chain managers can quickly renegotiate with suppliers

Exhibit 3
Fair-Return Pricing Provides Supplier with Consistent Income and Protects Buyer from Spikes



Source: Booz & Company

Exhibit 4
The Roots of Supplier Costs



Source: Booz & Company

that have used rising commodity prices as a reason to increase prices. As commodity prices come down, many suppliers will offer price reductions. However, without a solid understanding of a supplier's underlying costs, utilities won't be able to determine if the supplier is passing along all of the reductions. For example, at one utility, such cost

modeling identified an additional 7 percent price reduction for power transformers. While the supplier had reduced its prices, the cost modeling exercise revealed that it was also pocketing a portion of the price differential as commodities fell, whereas it generally passed through all of the increases during the up-cycle.

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USING TEAMWORK TO CONSERVE CASH

Chief financial officers (CFOs) at utility companies are already leading the search for cash, so supply chain managers must work with CFO teams to make effective decisions, such as whether discounts for paying early are more advantageous than longer payment terms. Most of the opportunities to generate cash through supply chain-related initiatives will require cross-functional support and participation, so full support from the executive team is essential. For example, if the SCM team challenges budget owners on open-order requirements or future project plans, the line executives need to support these challenges as constructive rather than as SCM meddling in their business decisions.

Program management discipline applied to SCM cash initiatives will also increase the probability of success. For example, basic tools like clear project charters, quantitative targets, milestone tracking, and key performance indicator (KPI) monitoring will

ensure progress toward desired results and provide feedback if efforts are not going as planned.

Supply chain improvement, including review of generation, distribution, transmission and corporate spend categories, can yield significant savings. By addressing issues such as spend-category strategy, process and organization improvement, IT support, and inventory optimization, one utility realized more than \$200 million in savings through supply chain initiatives.

To combat the dual challenges of the downturn and the credit crunch, utility supply chain managers must regularly review their operations to find places where cash is being absorbed needlessly. By keeping an open mind toward operational change and renegotiating or reexamining supplier arrangements, companies can redirect costs more effectively. Doing so will allow companies to weather tumultuous economic times as successfully as possible.

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