

# Fundamentals of Energy Outsourcing

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As states around the country begin allowing retail customers to choose their electricity provider, industries of all types, shapes, and sizes are becoming concerned with the question of preparedness. *Will my company be prepared when the day comes? What are the risks? What's the upside? What's the downside?*

These are questions that must be asked and more importantly must be answered now. Planning for this major change in the energy industry will require most companies to devote a three-year effort before they will be totally ready for all systems to operate smoothly. It is essential that a company begin as early as possible. In most cases, outside help will be required and should be hired early into the program (during the initial planning stages).

To cope with many of these changes in this era of downsizing, rightsizing, restructuring, etc., companies are considering outsourcing their total energy requirements, not only electricity, but also natural gas, and other energy-related commodities.

This article discusses the fundamentals of outsourcing, how to prepare for outsourcing, and what to look for in an outsource company. Pitfalls and issues of concern that should be considered prior to entering into agreements with an outsource company are identified.

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## WHAT IS OUTSOURCING?

Outsourcing, like beauty, is in the eye of the beholder. While it may have a different meaning from one individual to another, it basically is the process of turning over the function or activity of a group, depart-

ment, or company to another entity specializing in that function. A clearer understanding may come from looking at the goal(s) of outsourcing.

### **Outsourcing Is Not a New Concept**

It has been around for many years. Over the last several years, it seems to have gained momentum in certain industries. The Information Technology and Information Systems functions have been major users of the concept. Using third parties to operate computers and other electronic equipment to store and complete data, credit card operators have used outsourcing to manage billing and data management functions.

Some companies have used third parties for the manufacturing of products. The primary company continues to manage the marketing efforts while the third party is responsible for all fabrication and/or manufacturing.

The automobile industry has used outsourcing for many of its plants and assemblies. In cost comparisons for one item, car seats, the average labor cost of the seat by Ford or GM is approximately \$45 an hour with benefits. Parts suppliers can do the job for an average of \$27. This is the reason for the success of companies like Lear Corp., the largest freestanding supplier of auto interiors. Before beginning to debate the unionization issue, recognize that both Lear and the auto companies are working under an agreement with the United AutoWorkers.<sup>1</sup>

By the way, Nike does not make shoes. Nike sells its own design, but outsources the manufacturing.<sup>2</sup>

Pharmaceutical companies are using third parties for research and development of new drugs. Where hundreds of millions of dollars are spent to bring a drug to market, the ability to use third-party research laboratories and technicians lets the primary companies spend their efforts on marketing and obtaining governmental approvals.

### **So What Is Outsourcing?**

It has been defined as the contracting for services other than core company activities. With the success that outsourcing has brought to many companies, it is becoming defined as contracting for service other than a company's competency. Either definition conveys the concept of hiring an outside company to be responsible for a function or operation that the primary company does not wish to expend resources on to develop or maintain when that function can best be accomplished by an

outside party with the necessary expertise. Reducing the primary company's administrative costs and performing the function at a reduced rate are the basic features of outsourcing.

Many companies today have some form of outsourcing included in their current operation. It may be the mail service, or sections of the Departments of Human Resources, Relocation, Travel, Information Systems, Security, Plant Maintenance, Accounting, etc. The requirements of expanding outsourcing to more vital operations for most companies is the same as for any change in any other company policy. Educating senior management and defining the limits and control of the outsourcing activities are musts.

While it may not take very much effort and education to convince senior management that outsourcing nonvital elements of the company can be cost-effective, it obviously requires a more in-depth education and greater effort to initiate an outsourcing activity of a dollar intensive function such as energy. Nevertheless, there are economic advantages to outsourcing the energy function. Those companies that do not have complete energy expertise in-house will be forced to seek outside help. The energy industry is becoming far too complex for "part-time" energy management.

Even at small plants, the plant manager, who has been performing the energy procurement tasks in the past, will no longer be able to stay abreast of the changes in the energy industry well enough to be able to make informed decisions. The stakes will be too high and the risk factors will begin to escalate as the energy industry becomes competitive.

Some companies may find that developing a full-time energy group is an investment they do not wish to undertake. In any event, outsourcing may provide the ideal opportunity for companies to manage their energy needs.

## ENERGY OUTSOURCING

Energy outsourcing does not mean to simply contract with an outside party and forget about energy altogether. The ultimate responsibility of the energy activity continues to remain with the primary company. The third-party contractor will work alongside the primary company's representative, but it cannot set policy for the company. It cannot determine on its own what the company's energy strategy will

be, nor can it implement the company strategy without the company's approval and direction. Therefore, it is extremely important that certain steps be taken in order for outsourcing to be successful.

## PLANNING STEPS

There are several steps that a company should follow in the development of an outsourcing plan.

1. Obtain information on the energy commodities and establish a reference source. This may be through a joint in-house effort or by hiring an energy advisor to provide that function.
2. Consolidate the historical records of energy usage for all areas. It is extremely important that the company's energy requirements are known and evaluated for prioritizing and for identifying high cost and potential problem areas.
3. An in-house energy team should be established. The team should include all stakeholders inside the company. This would normally include Purchasing, Production, Finance, Engineering, Middle Management, and usually consultant(s) and outside contractors. It is important that middle management participate in order to provide support for the initial efforts, as well as to provide the pipeline to senior management when it is time to bring them into the program.
4. The team should then establish goals, develop strategies, and obtain senior management approval. Before establishing goals, it is important that the team becomes informed about the laws and regulations applicable to their area. This may be obtained through various sources: attorneys, energy advisors and group associations participating in energy activities.
5. Prepare a Request for Proposal (RFP) to solicit proposals from energy outsourcing firms. The RFP is an excellent tool for learning about new options available in the marketplace and to confirm that

conventional options are available at competitive prices. It also assigns the control of the project to the issuing party. This is important in maintaining a focused effort on the progress of the project.

The RFP is normally distributed to a "long list" of firms consisting of usually 10-12 companies. Based upon the evaluation of the responses to the RFP, the list will be reduced to a 2-4 firm "short list" for detailed discussions and formal one-on-one interviews. A final selection is made from the "short list" of companies based upon the combination of the RFP evaluation and the information obtained during the interview.

The development of the RFP will require the service of an energy advisor in order to focus on the appropriate objectives, to identify qualified outsourcing companies capable of performing the function, and to properly evaluate the proposals, objectives, and contract business terms. Attempting to achieve this step without the proper knowledge and experience could result in a less than satisfactory performance of the outsourcing effort. Therefore, it is emphasized that experienced help be involved in this stage.

6. Monitor the program. After the proposals have been evaluated, the successful firm selected and the contract executed, the work does not stop. It continues. Each aspect of the energy activity must be reviewed, and goals and objectives revised to comply with changing laws, regulations, and company policy. The economics of the venture should also be evaluated on a continuous basis to ascertain that the program is working. The evaluation should be performed as an energy team function.
7. In order to properly evaluate the success of the program and to identify issues to be addressed with suppliers and other parties when contracts are up for renewals, the activities of the energy team and the outsourcing company should be recorded in a written report.
8. Start early. It is not too soon to begin planning for a successful energy program.

## WHAT TO OUTSOURCE

What to outsource depends upon the nature of the primary company, its core business, and its competencies. The normal energy commodities include electricity, natural gas, coal and fuel oils. The activities would encompass the procurement, contract negotiations, bill review and reconciliation, general management and reporting functions.

Other areas to consider are the Energy Island and the Energy Center concepts. These two concepts normally provide for the conveying of physical energy-related assets to an outsourcing (third party) company. With both concepts, the third party will conduct operating efficiency studies and improve the efficiency of the equipment, of the operation, and the overall energy supply chain inside the facility's fence.

The Energy Center is very similar to the Energy Island concept except that it will normally include new generation equipment in addition to the efficiency improvements of the Energy Island. With either concept the revamped operation should produce improved energy savings to the host company. In addition, the company will normally be able to reduce its operating and maintenance cost by transferring the obligation to the third party as part of an equipment lease or ownership. The company is then free to direct its capital toward core business activities. The preferred concept depends upon the host company's requirement for on-site generation.

One other advantage of an outsourced function is the ability to aggregate energy usage at multiple sites. This will be a very significant advantage for some companies when the electrical power industry is restructured. Pipeline companies should find aggregation very attractive.

## BARRIERS TO THE SUCCESS OF OUTSOURCING

Many companies that have utilized outsourcing as a tool have experienced a great deal of success. Nevertheless, as with any activity, there is the exception. There have been reports of cases where outsourcing has not been successful,

One reason given for the reported failure is that the outsourced operation did not have the experience necessary to accomplish the work. This can be attributed to inexperience of the outsourcing company.

A reason given for other failures was that the outsourced function

was a major operating element of the primary company's core business and the coordination of activities among the various operating groups (including the outsource company) was not effective. This appears to be a communication problem rather than an outsourcing issue. An additional point to remember is that in order to maintain a smooth transition and effective operation, it is extremely important to bring all of the operating groups in on the project early and obtain their "buy-in" to the project.

A third reported factor leading to an unsuccessful outsourcing operation was that the function was not managed well. This is not a surprise. It is difficult to think that anything will be a success if it is not managed effectively. As stated earlier, the work continues after the contracts are executed.

It is very important that a competent company be contracted to manage the outsourced function. It is equally important that the primary company work directly with the outsource company. Success is a function of planning, implementation, and management/control.

Already there were a number of companies involved in the energy management function. It has become a very competitive industry. The "Buyer Beware" is certainly sound advice for anyone to consider when contracting for energy management services.

Be cautious of companies offering to perform the energy management function based upon compensation determined as a percentage of energy cost savings. It is difficult for a third party to perform this function in an unbiased manner. Savings can sometimes be identified by exercising options that are not suited for the primary company's operation. This leads to false economy and in some cases to additional cost.

As a minimum, it is very likely that the primary company will seriously overpay for the energy management services. While this option may in certain cases provide a benefit, proper guidance in its use is recommended.

## CHARACTERISTICS OF AN ENERGY MANAGEMENT FIRM

When selecting a firm to manage the company's energy, consider the following.

1. The firm must be experienced.
2. The firm must be objective. It is very difficult to imagine that any

firm that is in the business of selling a commodity can be unbiased when advising a company on the purchase of the commodity. This is akin to "hiring a wolf to watch the hen house." Yet, there are businesses that continue to hire companies that do exactly that, thinking that the commodity can be purchased at a discount. The discounted portion of the rate, if it is discounted, is usually recovered in some other fashion. In a multiple year contract, the second year rate may make up for the first year discount. Be cautious when dealing with discounts. Be sure that all details are disclosed and that the rate is fully understood.

3. The firm must be results oriented. The goals set must be achieved and the results tabulated. Only then will the true value of the venture be validated.
4. Be cautious when contracting for either the Energy Island or Energy Center. If the program includes a third-party capital spending option, consider that in most circumstances the amounts of funding that the third party contributes to the venture must be returned. If there is only one party purchasing base load energy from the venture, then that party will be returning the capital plus any incremental return on investment to the third party. The capital outlay by the third party then becomes merely a loan to the primary company. Usually the primary company will do better to obtain the loan through its own sources. However, if the primary company wants to keep the debt off of its balance sheets, then the third-party capital contribution approach may be acceptable.

## CONCLUSION

**With the proper planning, education, and monitoring/control, outsourcing can be an effective alternative to the time and expense of developing the in-house expertise, Real operating cost savings can be achieved, and company dollars diverted from the development cost of energy groups are usually needed for capital improvements in the core businesses of the primary company.**

### References:

<sup>1</sup>Forbes 1-11-99, p. 156.

<sup>2</sup>Forbes 10-20-97, p. 60.

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#### ABOUT THE AUTHOR

**Terry S. Cowan** is vice president of the Energy Procurement and Management Group. In that capacity he assists clients in their day-to-day energy management and in developing and implementing energy, strategy, electrical power generation development and power sales, and participates in BAI's marketing and client outreach activities. He has served on the executive committees of the Northwest Industrial Gas Users Association (NWIGUA), Tennessee Valley Industrial Committee (TVIC) and as Chairman of the Louisiana Energy Users Group (LEUG).

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