



Considerations for centralized utility services

With the consistent drive to improve performance and reduce cost, industrial companies are increasingly turning to utility experts to provide steam, cooling, power, water and wastewater treatment for their production facilities. Steam supply is the most common utility service from independent power producers in an “over the fence” arrangement. A centralized utility service expands the scope to supply all of the utilities required for production, providing added benefits and, as a result, increasing complexity. The added benefit is specific to each project and may include improved performance, reduced impact to production, reduced cost, improved efficiency and allocation of capital, and offloading of expenses for upgrades or new infrastructure. This requires additional consideration in the acquisition of existing infrastructure, third-party investment, and transitioning of operations and maintenance responsibilities. For industrial parks with multiple tenants, a central utility service can eliminate the distraction inherent to delivering utilities to multiple customers. This article reviews the core components of an effective utility services agreement and an approach to its development.

Core components of an effective agreement

Effective central utility services are best delivered through performance agreements. Simply stated, services are provided as required to meet the demand, quality and availability of utilities guaranteed in the agreement. The agreement does not specify the level of staffing, maintenance or investment required to meet performance goals. These resources are the responsibility of the service provider to manage. Access to technical support, new technologies, maintenance subcontractors and fuel supply are examples of areas that require careful consideration.

There are always some stranded services that best remain with the production facility, especially for activities that reside inside the production complex and are uneconomical to separate. Some examples include site security and first responders for emergency incidents. Battery limits specifying the boundaries for operations and maintenance services should be clearly delineated, especially for distribution networks. Valves, buildings and substations provide ideal reference points for demarcation.

Performance agreements also provide protection from unanticipated expense, as their structure places responsibility on the service provider to manage the cost and risk of delivering utilities within a

fixed-fee structure. The delivered cost of utilities remains stable and is not impacted by changes in staffing level, maintenance expense or major overhauls, which are managed to maintain utility delivery. By comparison, operations and maintenance programs based on headcount or a specified maintenance budget typically result in additional cost being passed on to the customer to protect the supplier.

Capital investment and optimum allocation of capital are core components of most utility service agreements. The cost of upgrades or new infrastructure can be substantial and is most economically managed under a long-term agreement. In addition, responsibility to maintain the efficiency and performance of utility assets over the long term drives optimal maintenance practices and the quality of upgrades or installation of new assets. Projects with significant scope often have a term of 20 or more years. Over the long term, fixed-fee structures require a mechanism to account for changes in expense caused by inflation. Published cost indexes supply an effective mechanism for doing so. The Bureau of Labor Statistics provides an objective, trusted source for national, regional and job-specific indexes, as well as indexes for materials that are specific to industrial facilities. The use of any such adjustment should be clearly defined and automatic. This provides clarity in the fee structure and relief from the burden of negotiating adjustments in the future.

Finally, utility service providers are compensated for the risk they manage in guaranteeing the delivery of utilities. Contractual remedies for nonperformance need to be commensurate with the risk and reward reasonable for this service. Service providers do not reap the typical returns of the production facility. As a result, they cannot be expected to fully compensate for the risk of lost production in the event of a breach in performance. Improving utility performance with a utility service reduces the actual risk of lost production through contractual remedies that are reasonable relative to the services provided.

Key steps in developing an agreement

So, what is the ideal path to get from an initial concept to a performing agreement? The first step is to define the objectives for a central utilities service, which begins with a thorough understanding of current challenges. Most successful projects begin with a core belief that the right utility expert can provide better performance than your existing team. Challenges are often

common from facility to facility and typically include lack of reliability causing lost production, excessive cost and inefficiency, substantial expense for infrastructure upgrades, and capital requests that compete with higher priorities in production. Management, engineering and support resources may also be lacking or focused elsewhere. Understanding accounting requirements and the approach to financial consolidation in any third-party investment is also important at this stage.

The second step is to develop a thorough benchmark of current cost and performance. A central utility service will transfer many direct and indirect responsibilities to the service provider. These should be adequately captured to get an accurate measure of value. The total cost of ownership goes beyond the operations, maintenance, fuel and capital expenditures dedicated to utilities. Stranded costs for management oversight, technical support, development and execution of capital projects, and the sourcing of services and materials are factors that require equal consideration. Performance can be assessed by the cost of lost production and, if pertinent, may include the impact of environmental permit violations. Both the short- and long-term capital investment required to achieve the same level of performance should also be taken into consideration.

Due diligence and access to relevant personnel, records and assets at the site level are required to support the performance guarantees that make up an effective agreement. The standard request-for-proposal process is ill-suited to selecting a service provider, as substantial resources and collaboration are required from both buyer and seller to develop a firm proposal. In reality, what is required is a development partner with experience in similar utility projects and a successful record of closing agreements, executing projects and maintaining performance over the long term. A thorough understanding of your objectives and a bilateral commitment to resources are key.

Screening of potential partners can be supported by requesting preliminary guidance on their approach to meeting your objectives. This can be accomplished through development of a preliminary make-or-buy analysis that compares the benchmark of current cost and performance to that of a utilities service. To be effective, it should include a description of the approaches proposed to meet the facility’s objectives. Preliminary guidance is nonbinding and can be completed under a standard confidentiality agreement, which

protects proprietary information and the work product developed by the service provider.

With the selection of a development partner, the project is positioned to enter into the detailed development phase (i.e., development of binding proposals validating preliminary guidance, contract negotiations and project closing). A memorandum of understanding or project development agreement (PDA) can provide guidance through this final phase. While nonbinding in regard to execution of the overall project, the PDA does provide a detailed road map as to how the project will be executed. In the alternate case, it provides the process to terminate further efforts between the parties. Working relationships within a PDA are typically exclusive, and use of the work product is limited to an agreement between the parties.

An effective PDA provides a schedule of key milestones, such as completion of contract templates, binding proposals, executable agreements, final approvals and project closing. It also defines project criteria taken from the preliminary guidance provided previously. This helps set guidelines to continue contract negotiations after binding proposals have been completed. A term sheet may also be incorporated to define general contract provisions. Finally, in the event that the project does not move forward, compensation for development efforts that would otherwise be recovered from an executed project should also be addressed. It is common to cap the reimbursement amount, which may also be contingent on the service provider meeting the project criteria.

Conclusion

In closing, utility service agreements can be of significant value to industrial sites, as they provide an effective means of improving performance, reducing cost, offloading the expense of upgrades and allowing manufacturers to focus on core production. Services are best delivered through performance agreements that clearly define the demand, quality and availability of utilities. The development of performance benchmarks on the current infrastructure is the first step in evaluating the benefit of a utility service. Ultimately, given the resources required, the detailed development and closing of a service agreement are best performed with a single utility partner under the guidance of a PDA.

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