

# The Contract Operations Market: Looking to the Future

by Brian Oakley

Only two short years ago, estimates of the growth prospects for the water and wastewater contract operations and maintenance ("O&M") market indicated that the industry would reach \$3.1 billion in annual revenues by 2004. Based on the 2001 survey results, it appears we will have to wait several years before O&M revenues will clear the \$3 billion mark. While the growth of the private sector's penetration into the contract operations and maintenance market may have slowed a bit, everyone wants the answers to two questions: Are the growth drivers still there; and how will the industry behave going forward? A detailed examination of market trends and competitive activities suggests that this market is healthier than ever.

## Enduring Growth Drivers

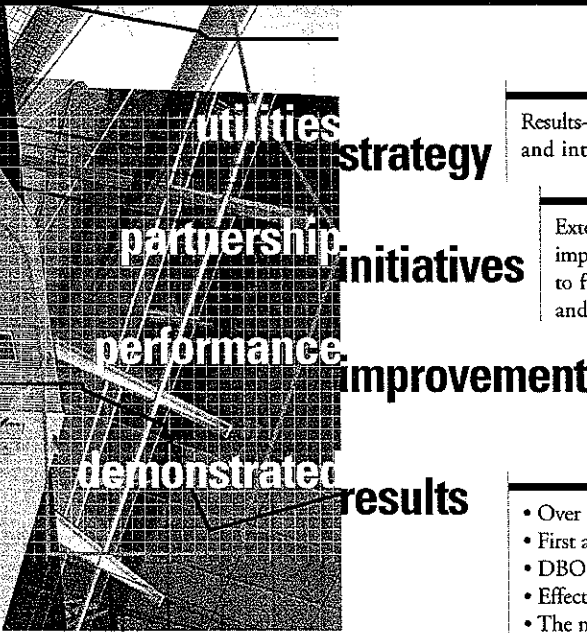
For many industries, 2001 was a year that presented numerous and diverse challenges. The contract operations market was no exception, and although these challenges may affect growth in the short-term, long-term drivers and the emerging signs of maturity in the business provide an excellent platform for long-term industry growth, as demonstrated by the following factors:

➤ *Long-Term Economic Drivers:* Municipalities face staggering capital expenditures over the next 20 years to address aging infrastructure, new regulatory guidelines, and economic growth. Although there is some discrepancy among the cost estimates generated by various stakeholders, there is con-

sensus that municipal water and wastewater utilities will face truly massive capital requirements over the next two decades. To date, efforts to obtain federal assistance have been unsuccessful, forcing municipalities to contemplate rate increases in the double-digit range, or seek more cost-effective solutions for addressing capital improvements needs.

➤ *Industrial Outsourcing:* As noted in the body of this PWF issue, industrial outsourcing is viewed as a high-growth market for operators of water and wastewater systems. Penetration into this market segment is on track with historical projections, and profitability potential in this segment is considered to be higher than on the municipal side.

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Interestingly, a key driver for this growth is the rising cost of municipal treatment; often high strength wastewater generators are subject to special surcharges. As rates increase, these users find the installation of on-site treatment systems to be more attractive. This is frequently being accomplished through long-term design-build-operate ("DBO") service agreements with contract operations firms. As the flows and loadings of these users decline, municipalities are faced with the unenviable task of recouping ever-higher costs among fewer customers.

➤ *Demonstrated Results:* Based on industry performance during the 1990's, there is little debate over whether public-private partnerships in water and wastewater can deliver results. In particular, the widespread acceptance of the DBO project delivery model illustrates success, both in innovation and in the delivery of value to customers.

### **Growing Pains**

From its inception, the O&M market has had to overcome numerous barriers impeding its growth. Industry veterans are accustomed to long development lead times and are adept at addressing the challenges they may confront during the sales process. However, the confluence of these challenges seemed particularly evident in 2001. The following trends received a lot of attention and discussion among industry stakeholders.

➤ *Renewed Trust in the Public Sector Workforce:* The September 11th tragedy highlighted the often-heroic efforts made by public sector employees in carrying out their day-to-day responsibilities. Against this backdrop of self-sacrifice came the recognition that our public infrastructure is vulnerable to terrorist attacks. As evidenced by the federalization of airport security workers, government officials have temporarily put aside the outsourcing debate and placed their trust in public sector employees.

➤ *Municipal Re-Engineering:* Over the past five years, the public workforce has achieved measurable success in improving operating efficiency. In some cases, this has lowered the potential savings related to contract operations and in turn, undermined the momentum that drives specific privatization initiatives. However, despite this initial success, the absence of competition in the municipal environment will continue to put these efforts at a disadvantage.

➤ *Organized Labor:* Participants in the contract operations market have been slow to develop a coordinated response to the opponents of privatization. Organized labor, on the other hand, is, well, organized. Information and "toolkits" for resisting privatization are readily available on government employee union Websites and, as illustrated in Public Citizen's recent publication of "The Big Greedy," mud slinging is dished out in equal doses.

➤ *Unsustainable Risk Transfer:* The privatization movement has encouraged the growth of the procurement advisory business. Although the emergence of this market niche may provide additional opportunities, some consultants and attorneys have been criticized for "going too far" in taking advantage of the highly competitive nature of the business. One has to look only at the problems experienced by certain engineering and construction firms to see that one-sided risk profiles can undermine an entire company's financial health. Over the long run, this is not good for customers or for the industry's well being.

➤ *Cannibalistic Competition:* Based on some of the competitive tactics employed by industry rivals, it is safe to conclude that the industry has not done itself any favors. Although overly aggressive pricing and negative sales tactics appear to be costly over the long term, perhaps the most confounding tactic is the bid protest. For the

loser of a competition, the practice of protesting a bid result does not appear to offer any upside. After all, having made its decision, a public body is unlikely to award a contract to the entity that challenged its decision. Therefore, the most likely outcome is a delay in contract execution or the cancellation of a contract. Both of these outcomes are detrimental to the growth of the industry. In fact, in Lee County, FL, a bid protest initiated a chain of events that ultimately unraveled the \$10 million/year O&M contract, placing operations responsibility back in the hands of the public sector employees.

### **A Maturing Process Begins**

Given the compelling market drivers, it appears that public-private partnerships are, and will continue to be, a viable option for consideration as municipalities face the daunting task of updating, expanding and operating their water and wastewater infrastructure. While this has fueled market growth in the past, the competitive environment and long project development cycle have limited profitability for many industry participants. However, signs of a maturing process are emerging as the industry continues to consolidate. In particular, in 2001 a number of positive signals appeared, including:

➤ *Improved Project Screening:* Contract O&M companies appear to be exerting more effort in evaluating project opportunities before investing in expensive project development efforts. Companies are considering the level of community commitment to a public-private partnership and their own chances of success before entering a competition. Screening criteria may even extend to an evaluation of the procurement team and its advisors. This is particularly true in higher profile projects where project development expenditures may exceed \$1 million.

➤ *Price Stability:* The industry "rule of thumb" for bid margins

appears to be 15%. While companies routinely dip below this level in competitive situations, most have learned or witnessed the hard lessons associated with an overly aggressive pricing approach. The result is tighter pricing among competing bids. For example, in a recent competition in Crystal River, Florida, the difference between the lowest bid and the highest bid was approximately \$150,000 on the \$3.1 million outsourcing project. An important outcome of more predictable pricing will be competition based on quality, differentiation, and service, laying the groundwork for greater customer satisfaction and improved profitability.

➤ **Consolidation:** Over the past five years, the industry has consolidated significantly. The integration of PSG's operations into US Filter Services, American Water Services' recent acquisition of former market consolidator, Azurix North America, and Southwest Water Company's purchase of Operations

Technologies, Inc. are contributing to a changing competitive landscape that is likely to be dominated by a handful of large firms. When combined with improved screening tactics employed by leading firms, this industry consolidation has resulted in fewer companies electing to bid on larger, high-profile projects

➤ **Horizontal Diversification:** While a number of industry participants have sought to acquire the water "value chain" (engineering, equipment, chemicals, operations, etc.), others have focused on horizontal diversification. In some cases, this has expanded water and wastewater operations contracts into other public works functions such as street repair, grounds keeping, beach maintenance and even animal control. In the municipal environment, realizing the benefits of this approach may be easier to achieve than a vertical integration approach.

➤ **Increasing Barriers to Entry:** As the industry has consolidated, the

threat of new entrants has begun to diminish. In the current environment, building a contract operations business of any scale would be nearly impossible without an acquisition. Even for small projects, the qualification requirements prevent less experienced operators from meeting the criteria.

➤ **Liability Concerns:**

Another positive sign for the industry is the rationalizing of risk allocation

between operators and municipalities. Industry leaders have been very public about their concerns over assuming unlimited risk, and it is likely that consensus will build on this issue. The recent formation of the Water Partnership Council, a CEO-only industry group, provides a strong indication that industry participants will work together to promote a basis for sustainable water and wastewater partnerships.

## Market Outlook

Long-term market drivers and nascent signs of a maturation process suggest that market participants may be entering a period where growth can be achieved without sacrificing profits and without assuming uncontrollable risks. Industry participants remain bullish on this market. An excellent indication of this prevailing attitude is the purchase price multiples offered or paid on recent industry acquisitions. Based on 2001 mergers and acquisitions activity, the long-held expectation of sellers to receive 1 times revenue or 10 times earnings before interest, taxes, depreciation and amortization ("EBITDA") has remained achievable.

Although multiples can be higher or lower based on a target's unique strengths and weaknesses, deal structure, and available synergies, 2001 transactions were consistent in terms of purchase premiums with other deals executed over the past five years. To justify this level of "strategic premium," a buyer has to assume robust growth and profitability well into the future, indicating that, when it comes to the contract operations market, investors still seem to be willing to buy into its potential. ■

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