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E&P SUPPLIER CONTRACTS

WHERE DOES ALL THE VALUE GO?

By Jake Leslie Melville, Philip Whittaker, and Pauwel Wiertsema

Over the past decade, many exploration and production (E&P) companies have significantly improved their procurement and supply-chain-management practices and have achieved material gains in the efficiency of their dealings with suppliers. Many E&P players believe, however, that they still have much further to go. In particular they suspect that there remains considerable hidden "value leakage" in their transactions with suppliers. What is more difficult to identify is where, precisely, the problems lie and to what extent they are resolvable.

To gain their insights on this issue, we conducted a survey of a cross section of companies that provide services and equipment to the E&P industry. Casting a wide net, we spoke with drilling contractors, OEMs, and companies engaged in well services, marine services, and engineering, procurement, and construction (EPC). What we heard surprised us, and we believe that our findings have significant implications for the E&P value chain. Most suppliers and service companies believe that there is indeed value being lost at the interface between them and E&P companies. They think that some of the issues still result from flawed contract framing and setup by E&P companies, despite the E&P companies' extensive optimization efforts on this front. But the suppliers we interviewed also stated that many of the problems arise because of the way that E&P companies execute and manage these contracts. Some of the suppliers mentioned poor contract management as an ongoing concern. Suppliers said that this holds particularly for the large, integrated E&P companies—ironically, the players that have invested the most in their supply-chain structures and functions in recent years.

We believe that the challenge of value leakage is one that E&P companies can address, but it will require them to rebalance their focus in their supply-chain efforts. Specifically, they will have to assign less urgency to the design of ever-more sophisticated contracts and incentives and spend more time improving basic contract framing, supervision, and management practices.

Sources of Value Leakage

Our discussions with industry suppliers identified 11 distinct sources of value leakage at the interface between E&P companies and suppliers. (See the exhibit below.) Value leakage in the contracting cycle falls into three categories: contract framing and setup, field operations and execution, and contract enforcement and administration.

Contract Framing and Setup. There are four sources of value leakage at the contract-framing and setup stage.

- *Global contracts specify universal standards that don't work well in some local markets.* In an effort to reduce unnecessary variation, many E&P companies that are engaged in cross-regional efforts with suppliers specify standards that are intended to be applied universally. Local conditions may, however, prevent adherence. A global contract of one international oil company (IOC) called for the use of a particular type of tool for wireline operations. However, operating conditions in the North Sea—where the company has tight reservoir assets—were inconsistent with the tool's use. The conditions there demanded instead the use of an expensive, specialized tool that was not stipulated in the frame agreement. This led to high incremental—and avoidable—costs for the IOC.

- *Tight contract specifications constrain suppliers' ability to cut costs intelligently.* E&P companies can tie suppliers' hands by establishing standards that prove too stringent and inflexible. One EPC contractor, for example, found itself using an unnecessarily costly approach to an engineering project because the E&P's contract stipulated very specific requirements during the front-end engineering and design phase. The inflexibility in the contract standards prevented the contractor from seeking practical opportunities to reduce costs and leverage some of the contractor's global experience gained from similar projects.

- *Contracts outsource risks that could be handled more economically in-house.* Some E&P companies lack the in-house capabilities needed to fully understand certain types of project risk (for example, the risk associated with variability in "metocean" conditions), so they outsource those risks to their suppliers. This, in turn, pushes up contract prices

Sources of Value Leakage at the Interface Between E&P Companies and Suppliers

Contract framing and setup

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- EPC contractors add unnecessary complexity to OEM solutions

Field operations and execution

- Relatively slow operations and decision making and an inadequate ability to mobilize drive up costs
- On-site knowledge of the contract is insufficient
- Suppliers stray from stipulated agreements to boost their revenues
- Inflexible procedures embed cost without reducing risk
- There is limited or no continuity in supplier staffing

Contract enforcement and administration

- Contract responsibility is fragmented and managed on a transactional basis
- Contract enforcement erodes over time

Sources: Interviews with industry suppliers; BCG analysis.
Note: E&P = exploration and production; EPC = engineering, procurement, and construction.

significantly. In many cases, it is more cost-effective for the company to bear the risk itself rather than pay the premium to transfer it to an outside party.

- *EPC contractors add unnecessary complexity to OEM solutions.* In many reimbursable contracts, EPC companies have greater financial incentive to add engineering hours than to reduce costs. This can manifest itself in their unnecessary adjustments to OEMs' packaged solutions—and unnecessary costs for the E&P company. One EPC contractor, for example, made a series of incremental changes to an OEM's drawings of a basic skid-process unit, revising the drawings 13 times. In the end, the E&P company paid for all the revisions because of the way the contracts with the OEM, EPC, and E&P company had been set up.

Field Operations and Execution. The following are the five sources of value leakage that we identified during the interviews focused on field operations and execution.

- *Relatively slow operations and decision making and an inadequate ability to mobilize quickly drive up costs.* Compared with small, agile E&P companies, large ones are relatively slow in operations, decision making, and ability to mobilize, which can mean more idle time and higher costs. Recently, an IOC operating in the North Sea took five days to complete a full wireline operation while a smaller, turnkey driller did a comparable job in only three days because of its faster on-the-spot decision-making processes and limited slack time in mobilization and demobilization activities.

- *On-site knowledge of the contract is insufficient.* In many cases, an E&P company's on-site asset managers and drilling supervisors lack clear understanding of a contract's details and complexities. This can be particularly problematic when quick decisions are needed or when a required decision pertains to concerns that fall near or outside the contract's borders. One wireline contract, for example, stipulated a fixed, relatively competitive cost for each batch of up to ten wellbore pressure samples. However, the E&P company's on-site representatives, unaware of the very high incremental cost for even one or two additional samples, often agreed to suggestions from the supplier for additional—noncritical—samples.

- *Suppliers stray from stipulated tools, services, and quantities in an effort to boost their revenues.* One supplier chose to use 25-kilogram bags of a mud chemical that were far more expensive per kilogram than the 50-kilogram bags stipulated in the contract. Another supplier, a well services company, pushed for and won the E&P company's approval to use a newer, more expensive wireline tool than the one specified in the contract, increasing the cost of the wireline job from $800,000 to $1.5 million.

- *Inflexible procedures embed cost without reducing risk.* To maintain procedural consistency, large E&P companies tend to follow their established procedures very strictly—even when equally safe and more cost-efficient alternatives exist. Whether or not testing is necessary for each particular application, one IOC systematically pressure-tests its logging tools in each of its wells before actual use, simply because the practice is part of the company's procedural standards.

- *There is limited or no continuity in supplier staffing.* Although many suppliers' staffs are currently stretched thin, it is still possible, in many cases, for E&P companies to demand the same workers for similar operations from project to project in an effort to better leverage learning-curve effects and enhance collaboration. For example, one E&P company, aiming to avoid having a different crew each time on a given rig, secured a fixed crew of engineers on retainer.

Contract Enforcement and Administration. Even when contracts have been well crafted, value is often lost through inadequate enforcement of the contract conditions.

- *Responsibility for the contract is fragmented, and the relationship with contractors is managed on a transactional basis.* Large E&P players commonly put the responsibility for a single supplier in multiple places, depending on the particular step of the contract cycle. Negotiators hand over responsibility to a contract owner, who then delegates supervision to field supervisors. Delegation and the spread of responsibility continue throughout the process, and, finally, postjob variations and disputes are handled by a finance team. This approach can, from the supplier's perspective, mean that there is no holistic overview of the relationship and that the relationship ends up being managed transaction by transaction. It can also preclude or reduce the chances of the company and its supplier working together to find common-sense solutions to problems and accepting the give-and-take of a long-term cooperative relationship.

- *Contract enforcement erodes over time.* Many E&P companies have had contracts with the same suppliers for extended periods. Such long-term relationships can lead to a gradual lessening of rigor in contract enforcement and the emergence of never-intended norms and practices. Following a renegotiation, one IOC, for example, allowed its contractor to bill the company nine hours per day for only eight hours of work in order to compensate the supplier for lowering its rates. Another IOC, in a gentlemen's agreement that had developed over time, allowed its contractors to stop work 30 minutes before the official end of their shift so that they would not be late for dinner in the mess hall.

In the course of the interviews, we heard many stories of inefficiency in the value chain. For sure, some E&P companies are more effective than others at managing their supplier relationships. Still, there is massive scope for improvement across the industry, and we believe that improving the interfaces between operators and suppliers is one of the biggest value levers the industry has for reducing costs.

How Should E&P Companies Respond?

There are several remedial and preventive approaches that E&P companies can take to minimize value leakage in their relationships with suppliers. We see the following as being the most critical:

Drive a commercial perspective into frontline decision making. Too often, decisions made by E&P companies' frontline personnel are based solely on operational criteria, typically, with the easiest or most expedient solution prevailing. E&P companies should provide frontline staff with incentives that foster the adoption of an additional—a commercial—perspective. Frontline personnel should also be provided with the financial information they need to make optimized day-to-day decisions on cost-benefit tradeoffs.

Institute end-to-end contract ownership. E&P companies that employ committed end-to-end contract managers and management resources are considered by suppliers to be superior partners because they make it possible to have more candid and fruitful discussions about targeted outcomes and tradeoffs. To determine whether or not there is a positive business case for end-to-end ownership, E&P players should weigh the incremental cost of having dedicated personnel assigned to a particular contract against the potential corresponding gains in efficiency.

Restrict global contract standards to elements that are truly global. Standardization clearly has its benefits. But attempting to enforce standards that are poorly matched to a given locale is a recipe for value leakage. E&P companies should set global standards wherever possible but recognize that some unique situations require flexibility.

Learn from smaller, more agile players. Most large E&P companies have considerable scope for becoming faster operationally and accelerating their decision-making processes, and they can do so without compromising safety or integrity. Procedures are critical, but they should not exist solely for their own sake. Larger E&P companies should examine their operational and decision-making procedures and weed out those that fail to add value.

Form strategic alliances with suppliers to formalize joint approaches for tackling value leakage. This can be a very effective long-term solution that can deliver a host of benefits. Although implementation of strategic alliances can be quite challenging, it is a path well worth exploring. (See "Strategic Alliances in Upstream Oil and Gas: Getting Serious About Collaboration," BCG article, April 2015.)

E&P COMPANIES ARE capturing—on paper—ever-greater amounts of value in their relationships with suppliers through increasingly sophisticated supply-chain practices. But they are behind where they should be in translating this contractually secured value into *delivered* value. The levers discussed above can help E&P players make the leap from the theoretical to the real and, in the process, take the performance and efficiency of their supply chains to the next level.

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