

Energy insights:
Cost containment

Driving sustainable cost reduction: Contracting effectiveness and compliance



Today's market volatility has energy companies scrambling to keep spending in check. Ensuring that existing procurement contracts are delivering on their promised value is a good start.

By Ray Slocumb and Bruce Orr

There's an old saying in business, used to describe the disconnect that occurs when a lack of communication or a breakdown in understanding between functions creates problems—“the right hand doesn't know what the left hand is doing.”

That well-worn cliché describes perfectly the situation that many energy companies find themselves in with regard to supply chain management at headquarters and contract compliance in the field. It's no one's fault; just a simple matter of organizational structure and human nature. The functions that create and authorize contracts with suppliers, vendors and contractors are not the same ones that require the execution of those products and services, and disconnects are born.

Yet despite their desire to find meaningful, sustainable cost reductions, many energy companies overlook this fertile ground for bottom-line improvement. Hidden away in years-old contracts, long-forgotten agreements and complex, 100-page covenants are terms and conditions that if not followed or used properly, can be costly indeed. Identifying these major contract provisions, and ensuring that there is compliance, awareness and transparency across the board, can deliver significant, ongoing cost savings as well as help companies improve operational performance and enhance financial controls.

The overarching objective in delivering sustainable cost reduction in your procurement function is to develop a program that delivers value by rooting out contract leakage, scope creep, delivery and quality failures, poor or perverse incentives, bad planning and demand management, ill-informed buying, deliberate contract manipulation, general waste and miscommunication.

Cost of doing business?

Consider the case of the contractor that trucked all the way to the bank.

Hired by a major refinery to provide maintenance labor, the contractor also charged a set hourly fee for equipment and vehicles needed to perform scheduled tasks. During turnarounds and other busy periods, the contractor used its own trucks to ferry workers around the plant to ensure that each day's planned tasks were completed on time—and charged a hefty rental fee for each vehicle.

After some further analysis, renting trucks day-in and day-out from the contractor in this manner apparently doubled the expense associated with hiring the contractor. The refinery supervisors didn't mind—it was just a “cost of doing business.” If that's what the contractor needed to get the job done, the invoices got paid.

The company, however, had a truck rental agreement with another equipment rental company that would have charged half what the labor contractor did. Whether the refinery staff didn't know about that agreement—or knew but was willing to pay more due to convenience or loyalty to the contractor—isn't the point. The “right hand/left hand” disconnect cost the company plenty of money... money that could easily be saved if someone was monitoring actual expenses with existing contracts to determine compliance and contract effectiveness. To make matters worse, the level of invoicing transparency by the contractor was poor, making it difficult to assess the overall cost related to the rental trucks.

Compliance pays off

Given the nature of the energy business, examples like the one on the prior page are commonplace. Supply chain contract compliance can slip due to any number of reasons: a lack of awareness on the part of decision-makers about terms and conditions, the desire to use one vendor over another, ambiguous contract terms, poor procure to pay controls, breakdowns in communication and more.

Sometimes, the disconnect resides at the vendor, with invoices that include off-contract or non-compliant items or service, incorrect pricing or overcharges.

Solving this issue requires a systematic, top-down program of ongoing analysis, reporting, communication and training. Contract compliance cannot be a one-time effort; there must be a long-term commitment to ensuring that the company utilizes its procurement contracts effectively—and its vendors and suppliers—adhere to written agreements.

Of course, for major companies that do business with multiple vendors across the country or around the world, contract compliance can seem like an unwieldy activity. That's the primary reason it so often gets ignored; the resources required to monitor spend and maintain compliance appear to be too great to make it worthwhile.

But with the proper focus, companies can prioritize their compliance efforts to get the most return on their investment in time and effort. For example, PricewaterhouseCoopers helps clients evaluate procurement contracting effectiveness and maintain compliance by focusing on:

- Contractor spend inflation over time
- Sectors of the business that are complex or difficult to monitor
- Non-standard contracts or unusual/complex agreements

Where is the money going?

Our Contract Effectiveness Assessment begins with an in-depth analysis of company spend.

The goal is to answer a number of key questions that can lead to significant opportunities for savings. First, where are the highest levels of spend within the company? And who are the vendors or contractors with the largest share of spend in those sectors?

Most importantly, what are the company's "pain points"—the costs that do the most damage to the bottom line?

While many energy companies can easily answer where the majority of supply chain spend resides, they often aren't certain exactly what is driving those costs. By benchmarking expenses and performing cost inflation analyses, we can quickly pinpoint areas where costs have been growing at higher-than-expected rates.

The next step involves conducting forensic contract reviews, which include in-depth analysis and interpretation of the terms and conditions of the company's most complex, spend-heavy agreements, along with contract user interviews and spend and compliance analyses. These reviews are designed to uncover the following compliance elements:

- **Is the contract being administered effectively?** Are company personnel utilizing the vendor or contractor appropriately? Is there understanding among field personnel as to the key terms and conditions of the contract?

- **Is there contract leakage?** Is the vendor or contractor billing accurately, according to the agreed-upon terms of the contract? Does the invoice language suggest that there are issues with what is being billed? Are there any off contract charges?
- **Are there problems with payment/control weaknesses?** Are there proper authorizations obtained for invoices? Is accounts payable or other responsible parties vetting invoices properly? Are charges properly detailed? Is a solid three-way invoice matching process in place?

As part of the forensic contract assessment, PwC determines if high-spend contracts have problems or lack stipulations that weren't contemplated when the original agreement was drawn up. For example, in the refinery situation described earlier, the refinery could request an amendment to the existing agreement that incorporates more competitive pricing for truck rentals or incorporate a demand management system that routes these rentals based upon need, availability, and the lowest cost provider.

Finally, it is important to rank priorities and identify the action items going forward. Where are the largest opportunities for savings? Where is there leakage that can be easily prevented or even recovered? What operational issues exist that prevent the company from closely monitoring contractor spend? These opportunities for substantial cost avoidance typically present themselves clearly once the forensic work is completed.

Tools and training make a difference

Within a couple of months, a contract compliance and effectiveness assessment can identify a number of areas where the company can save money on labor, materials, subcontractors, equipment rentals and more.

Typically, the action items uncovered during the assessment can be grouped into external activities—working with vendors and contractors to amend agreements, tighten vague language and prevent overcharges or off-contract spend—and internal, ensuring that employees understand the contracts they utilize to get work done and that everyone with purchasing responsibility adheres to existing procurement standards.

If the company has a good relationship with a vendor, and there is proof of substantial off-contract spend, then chances are good that the agreement can be amended to rectify the situation. Most vendors recognize that contract compliance is not intended to be intrusive nor punitive; the company has a fiduciary responsibility to monitor spend up and down the supply chain and insist that invoicing is transparent, accurate and fair.

Often there are one-time cost recovery items that can be pursued with suppliers, along with recurring opportunities for cost avoidance that can be captured by improving the company's contract management processes and controls.

Perhaps most importantly, contract compliance efforts can provide companies the information they need to show procurement staff and field personnel where there are major disconnects between their two functions, and the actual, real-world cost of those “right hand/left hand” issues.

It does no good for the organization to negotiate beneficial contracts with suppliers and contractors if the field doesn't understand the parameters of the agreement or doesn't fully utilize the agreement in its day-to-day operations.

Many times, decision-makers in the field simply don't know what individual items cost, or how contracts are structured, because those types of details aren't important within the company's overall culture. Energy companies with a "production first" mentality typically focus solely on getting the job done, regardless of cost. At those companies, a supervisor who pays \$250 a day for a specialty crane because the contractor is already on the job site — when a preferred vendor could provide a suitable crane for half that cost — may not even be aware that there is another, more affordable option. And while that extra spend on the crane is minimal in the big picture, the "convenience cost" of selecting vendors or suppliers based upon routine or old relationships can quickly add up when extended across the enterprise.

To make it easy for operations personnel to make cost-sensitive decisions, the company should provide regular, ongoing communication and training to ensure that buyers in the field understand the terms and conditions of the contracts they utilize to get work done. Providing proper tools, and regular monitoring of compliance, can help personnel make better decisions, follow procurement guidelines appropriately and even change spending behavior over time.

Smart energy companies are looking at more than just field expenditures. Information technology and telecommunications are two other major areas where contract compliance can capture significant savings. Hardware and software cost rationalization, outsourcing arrangements and overall contractor costs make it economically viable to invest in IT/telecommunications contract reviews and analyses.

Operational benefits

An effective contract compliance program has benefits that go beyond reducing day-to-day costs. The same effort can help companies uncover contract leakage in capital projects, and better evaluate contractors on their ability to stay within an agreement's terms and conditions and bill accurately when work is completed.

In addition, improving the company's overall understanding of its spend has an important impact on operational performance. When contract compliance is monitored and reported, decision-makers in the field are required to plan better, structure workloads more appropriately, communicate more effectively and manage projects with more precision. The operational benefits include:

- Immediate cost control stabilization
- Improved understanding of contracts and third-party value
- Clarity of contractual cost drivers
- Transparent contract management information to simplify decision-making process
- Better resource allocation accountability

In closing

The bottom line is that an effective contract effectiveness and compliance program can help energy companies remain competitive in the face of increasing margin pressure and rapidly increasing technological and operational costs. Companies that fail to control spend will find their break-even point on new and existing projects moving higher than that of their peers—a volatile scenario given the current environment of lower commodity prices.

Yet with the proper cost management and control strategies—including an active, engaged contract effectiveness and compliance program—energy firms can avoid cost in both the short- and long-term and strengthen their ability to compete in the global marketplace.

About the Authors:



Ray Slocumb is the Energy Advisory Practice leader of PricewaterhouseCoopers. In this capacity he manages over 150 professionals with varying backgrounds and skills related to business and systems consulting. His role includes managing engagements related to project management, process improvement, systems integration, systems strategy, ERP consulting and controls, data warehousing, IT Internal Audit, risk management, business process, security and technology services. He also frequently coordinates global PricewaterhouseCoopers resources for multinational clients. Ray is a Certified Information Systems Auditor (CISA) and a Certified Fraud Examiner (CFE).



Bruce Orr is a Director in the PricewaterhouseCoopers Energy Forensics Services practice with over 14 years experience in procurement and supply chain process reviews, contract compliance, contractual disputes, procurement investigations and forensic accounting matters. Mr. Orr has managed numerous engagements involving oil & gas and refining companies and has a strong track record in identifying and evaluating various contract and contractor issues, procurement and supply chain issues, and various accounting related issues for his clients. He applies a unique combination compliance expertise, investigative and analytical skills, process review, data analysis and accounting system analysis skills in order to identify substantive issues that bring value to his clients. Mr. Orr is a Certified Public Accountant, Certified Forensic Examiner and Certified in Financial Forensics. He is a member of the International Institute of Auditors, Licensing Executives Society, American Bar Association and Association of Certified Fraud Examiners.

About PricewaterhouseCoopers

PricewaterhouseCoopers (www.pwc.com) provides industry-focused assurance, tax and advisory services to build public trust and enhance value for its clients and their stakeholders. More than 154,000 people in 153 countries across our network share their thinking, experience and solutions to develop fresh perspectives and practical advice.

About the PricewaterhouseCoopers energy practice

Recognized globally for deep energy industry experience, PricewaterhouseCoopers has an extensive history of providing resources and proven solutions that enable energy companies to meet their business imperatives. By providing audit, tax, and business advisory services to the Supermajors and key National Oil Companies and the vast majority of the Fortune 500, PricewaterhouseCoopers' professionals possess the experience necessary to provide optimal insight and impact. The global energy practice of more than 3,100 professionals, including 300 partners, is headquartered in Houston, Texas, and is committed to building meaningful relationships with energy clients. Commitment to the energy industry goes beyond service delivery and is demonstrated by an additional focus on knowledge sharing accomplished through thought leadership publications, educational opportunities, and industry event participation and sponsorship.