

Energy Insights:
Cost Containment

Beyond short-term savings

Sustainable cost reduction delivers
long-term value

Focus on cost drivers and spending culture to create lasting value in today's cost reduction initiatives.

By Ray Slocumb and
Keith Considine

The past 15 months have seen unprecedented volatility in commodity prices and the long-term forecasts for economic and energy price stability remain uncertain. Despite price moves, there is some amount of déjà vu with respect to this cycle. When times are good, and oil and gas prices are rising, energy companies loosen spending constraints and invest vast sums of money to develop oil; service providers ramp up to meet demand; and the increased—or anticipated increase of—output creates opportunities in mid—and downstream activity.

Currently, however, rig counts are half of what they were in 2008 and commodity prices are a third or less than in 2008. In addition, the economy and the availability of credit have yet to show any true signs of breakthrough. Remember the let down in the early '80s?

Energy companies, like most industries, are working hard to manage costs through this cycle. And many will succeed—at least temporarily. At best, however, these efforts may lose momentum over time, the savings will leak away and inefficient spending may go back up when market conditions improve.

At worst, the changes made for the short term will damage corporate infrastructure or permanently scar the company's culture. Companies have gutted departments during lean times only to realize that those employees' skills and experience were critical in the long term. Others focus cost-cutting efforts on simplistic measures such as “no bagels at the morning staff meeting”—damaging employee morale while missing the point about where the meaningful dollars are spent.

Today's market presents a prime opportunity to move beyond traditional cost cutting measures that have a short period of impact. Why not turn cost elimination initiatives into efforts focused on creating a longer-term competitive advantage? By focusing on improving how work is accomplished throughout the organization and aligning the culture of spending with strategic objectives, companies can realize meaningful, long term value to the bottom line.

Of course, getting there takes a commitment to move beyond traditional cost reduction programs. To accomplish this type of sustainable cost reduction, companies will need to: create a common view of their critical cost drivers; standardize key processes; improve the linkage between planning, budgeting and decision-making; analyze contracts with suppliers and vendors; and implement policies that strengthen cost discipline.

Energy's unique challenges

In some industries (e.g., airlines), cost management is simply part of the everyday business philosophy. But the cyclical, price-driven environment in which energy companies operate—and the complexity of the value chain—can create distractions from day-to-day cost discipline. Often times, senior leadership is focused only on top-line growth or key operational metrics, such as reserve replacements and regulatory compliance. Other examples of energy industry challenges include:

- Numerous field and asset locations with varying degrees of management and management styles.
- Aging and changing technologies with a lack of integrated applications and data.
- Complex investment decisions with long lead times that require multidisciplinary knowledge.
- Heavy competition and resulting lower margins.
- Reliance on third-party suppliers and contractors.
- Environmental, health and safety requirements that drive preventative maintenance and integrity programs.
- Challenges around tracking and managing capital versus operating spend.
- Volatility in supply, demand and underlying commodity prices.

Why traditional cost reduction fails

Despite continual focus by some companies, cost reduction does not have a strong track record of truly providing positive change. Classic problems with cost reduction efforts are that they limit upside and in some cases destroy value. Typical reasons for failure include:

- Lack of long-term thinking. A lack of long-term thinking fundamentally limits any sustainable cost reduction program. Many executives find it difficult to manage short-term bottom line impacts for the sake of longer term benefit.
- Lack of basics. A lack of budgeting fundamentals around knowing normal costs—as well as a lack of financial discipline and/or process variability or instability—limits many efforts from moving beyond a one-time leadership driven effort.
- Focus only on low-hanging fruit. Companies that repeatedly look at SG&A expenses first often fail to address baseline operating costs and third-party spending where significant opportunities also exist.
- Failure to address cost management and control. The spend culture—who can spend, how they spend and how spending is tracked—is as important as the costs themselves. Do the delegations of spend authority match the delegations of execution responsibility?
- Inability to measure impact. Cost reduction benefits often get lost within annual operating results or measured only by in-period benefits. Without a strong monitoring process, it can be difficult to know whether cost reduction plans are achieving desired results. Problems were not created in one year and solutions will not come overnight.

In all industries, companies take a variety of approaches to cost reduction programs. One is the “top-down transformation” that includes big swings to offshoring, outsourcing and divestitures. This approach often ignores the remaining behaviors and decision-making processes that drove costs in the first place. Then there are “slash-and-burn” approaches that are focused on arbitrary targets without a vision beyond the current year, often resulting in fleeting benefits and missed opportunities.

Still another is the “wide net” approach, in which all departments conduct extensive brainstorming and benchmarking in order to identify efficiencies. This unwieldy process—in which departments are personally invested in maintaining their own budgets—rarely leads to any significant waste or sustainable benefit.

The path to permanent change

The problem with these approaches is that they fail to take into account the big picture—the end-to-end core business processes that cross multiple functions and typically account for the majority of a company’s annual spend. Investing in the capability of the field (e.g., commercial, engineering) to interact with the centralized functions (e.g., PSCM, Finance) is the most powerful way to reduce costs over the long term.

Where can these investments pay-off? What lies beyond discretionary spend cuts. Value can come from improvements in the following areas:

Cost management and control

- Attack budgeting processes to drive out unnecessary costs.
- Focus on improved processes, such as delegation of authority, estimating techniques, and budget owner skills training.
- Monitor for heavily weighted spending at the end of the fiscal period to evaluate whether spending was necessary or merely to “spend to budget.”
- Enable technology to support improved linkages between spend and the operational drivers via improved P2P processes and reporting.

Contracting and supply chain

- Perform targeted contract reviews to identify areas of value leakage related to recoverable amounts and to minimize off-contract spend.
- Improve contractor management capabilities to improve business fulfillment.
- Improve line use and understanding of key contracts via contract tools.
- Close the gap between the line and PSCM with activity planning and sector strategies.
- Develop strategic sourcing options that leverage the scale of spend.

Planning, scheduling, execution

- Upgrade capital and project portfolio management capabilities to better manage the risks, project governance and spend around capital projects.
- Evaluate maintenance process improvements to reduce reactive work and improve ability to aggregate demand and leverage supply chains.
- Improve the use of working capital through the focus on inventory management.
- Improve discipline in turnaround processes with better front-end loading and planning processes to control scope, budget and duration.

Performance management and continuous improvement

- Develop a spend awareness culture and encourage continuous improvement from the top down. Distinguish between value investing and wasteful spend.
- Link long-term strategy with execution roles via improved reporting and better incentive alignment.
- Synchronize finance and operations view of the business to focus on key business drivers.
- Improve communications on strategy and performance. Clear accountabilities and creating a culture that supports transparency on “reds” as well as “greens.”

Culture makes a difference

Sustainable improvements often require changing the culture. Senior management must set the tone and lead the way. Coordination and communication between functions is essential.

The message to employees is that costs are not simply a result of tasks. Companies that develop a culture of planning and cost control understand that proper planning enables businesses to work toward maximum effectiveness. It also makes it possible to leverage scale with vendors and in many cases, fosters a closer relationship with key third parties who appreciate the opportunity to work as a partner rather than as a supplier.

How can companies take advantage of the lull in current activity and change their culture? Step one is to create a base for the long-term with three primary tasks.

1. Establish a cost baseline by objectively answering the questions: What do we spend? And where do our dollars go?
2. Scrutinize discretionary spend and identify the non-value creating expenditures that should be cut. Clarify operating cost drivers through a bottom-up analysis, linking financial plans to operating plans to provide transparency, improve accountability and enable measurement of cost reduction activities. Use the exercise to identify the items you can fix today and those that require a longer term plan.
3. Take a hard look at strategic supplier contracts. Ensure that sound buying decisions are being made with vendors and suppliers.

With this foundation in place, work can begin on changing the company's long-term capability to cost management. Doing so will likely require investments in process re engineering, technology and potentially organizational changes. Ultimately, the goal is a corporate environment that encourages individual responsibility for managing and controlling spending. With senior management's buy-in and guidance, this transformation is possible but is a long term endeavor.

Avoid the major pitfall

Being successful in any type of large-scale change project requires success in creating behavioral change—which is something well beyond process change. Changing the culture and employee attitudes through robust communication is critical. Oftentimes, when large-scale change programs are embarked upon, creating buy-in through frequent communication throughout the organization is not prioritized high enough or executed effectively. Change can create employee morale issues, turnover and quality issues, all of which may negate the positive impact desired from the program. Avoid this major pitfall by ensuring your program addresses both process change and behavioral change.

Long-term thinking produces long-term results

Cutting costs and investing in the capability to manage costs are different. Taking a long-term, systematic view of how core business processes and organizational structure support cost management requires a clear vision and discipline by the entire organization led by senior management. However, by building a culture that values planning, efficiency and promotes cost ownership, sustainable benefits can occur and deliver bottom-line results – no matter what the external environment brings.

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).

Keith Considine is a director in the Energy Advisory Practice. Keith focuses primarily on finance and risk management activities and has extensive process and control improvement experience and manages operational engagements focused on optimizing system configurations and reporting processes to improve performance and reduce risks. Keith has managed several projects which leverage his understanding of the requirements of FAS 133, 404 and the regulatory requirements (e.g. FERC, PUCT, etc.) impacting PwC's Energy and Utility clients. Keith also has deep experience in the workings of the front, middle, and back offices; including working with numerous trading and risk management systems.

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