Combating cost escalation

Three areas Canadian energy companies can reduce costs and improve operational performance
Contents

1 Leader’s message
   Three areas Canadian energy companies can reduce costs and improve operational performance
2 1. Third party spending
4 2. Labour and contractors
5 3. Productivity
7 Looking forward
Toyota Motor Corp.’s production line became one of the most studied manufacturing systems during the recent recession. For decades the Japanese company operated by a philosophy of “the complete elimination of all waste” that drove to the most effective and cost efficient processes.

While many manufacturers spent the better part of last decade trying to emulate Toyota’s lean production system, the practice has started to spread to other businesses and sectors. A handful of lean business programs have been created in the energy sector, and companies have tried to adapt certain Toyota-like practices to control costs as they recover from the downturn.

Capital costs in the energy industry continue to rise due to higher rates for materials, equipment, labour and oilfield services. With today’s uncertain markets, cost containment is an important strategy for increasing cash flow, creating a competitive advantage, driving shareholder value and ensuring long-term business sustainability.

The cost of drilling a typical well is considerably higher than it was a decade ago due to innovative technologies that have provided access to resources that were previously uneconomic to produce. The high cost of developing these assets has translated to higher operational risks. All operational aspects must now fall in line to contain costs; from engineering, construction, drilling and completions to increasing environmental and regulatory requirements.

The ability of energy companies to keep a miserly philosophy of “a penny saved is a penny earned” and maintain costs will be a closely monitored aspect of business performance. Making small adjustments and striving for “the complete elimination of waste” can make a big difference in overall performance, and in this publication, we look at three areas that Canadian energy companies should focus on to reduce costs and improve operational performance.

PwC is uniquely positioned to assist companies in achieving operational excellence. As the leading Canadian energy industry professional services firm, PwC Canada’s Energy practice has more than 1,000 partners and members delivering industry-specific solutions to more than 1,600 energy companies of all sizes. This document is published by PwC as part of our Energy Visions program, a series of publications and events that provide context around issues affecting the oil and gas sector.

Visit www.pwc.com/ca/energyvisions for more information on our Energy Visions program and our comprehensive suite of professional services.

Reynold Tetzlaff
National Energy Leader, PwC
1. Third party spending

Third party costs make up a significant portion of the annual budget for most energy companies, regardless of the resource or the stage of the business. While third party costs for companies in the manufacturing industry typically make up between 30-40% of the budget, in the oil and gas industry it ranges between 60-80%.

Since a large proportion of those expenditures fall with third parties, it is imperative that such spending is managed effectively in order to first contain, and then reduce costs in capital and operating budgets. Two areas where companies can effectively manage their spend is by examining the supply chain structure and taking a holistic view of spend.

Category management:

Rather than looking at spend on an individual project, asset or operating budget basis, an emerging approach for companies is to look at spend on a category by category basis across the entire company. With this strategy, companies can analyze how much, and with whom, money is being spent for a specific category, such as engineering, contractor labour or materials. Companies can then organize themselves with cross functional teams to manage each category and realize benefits such as improved project performance, supplier rationalization, reduced total cost of ownership, increased asset availability and obtaining the right balance of third party and in-house capability.

Holistic view of spend and organizational design:

Procurement is typically de-centralized and fragmented in many energy companies with purchasing responsibility falling to project managers, area managers or field personnel. Moving to a centre led procurement model provides more control and oversight on company spending. A centre led governance model in procurement can also create a higher level of compliance and reduces additional strain on field workers. In balancing the need for centralized control over purchases with the efficiency needed in the field, many organizations have adopted a hybrid model. In this structure, strategic purchasing is managed and performed centrally, and routine day-to-day purchasing is managed at local field offices.

Both strategies benefit greatly from the implementation of procurement-to-payment technology, which provides visibility to manage contracts and commitments more effectively. These strategies have been utilized in other margin constrained industries, such as manufacturing, for decades and energy companies have an opportunity to gain significant value by implementing similar strategies.

Companies that have implemented category management and organizational design strategies are delivering double digit returns on investment and usually see reductions of 10-20% in their third party spend.
Companies that have implemented category management and organizational design strategies are delivering double digit returns on investment and usually see reductions of 10-20% in their third party spend.
2. Labour and contractors

In 2011, the first wave of baby boomers reached 65 years of age. The Petroleum Human Resources Council of Canada estimated in a 2012 report that to replace retiring workers during the next decade, the industry will need to hire 39,000 people. If industry activity continues to grow, the number of new workers needed could be as many as 130,000. This presents a set of unique challenges to the energy industry.

Companies will need to examine their resources and find creative staffing solutions to accommodate the shifting demographics, including the use of contractors, part-time and semi-retired specialists. The energy industry will also have to make it a priority to capture the critical management, technical and organizational knowledge of the more experienced generation, and transfer this knowledge to the next generation of workers.

Workforce strategy:
Companies that understand and map their core business priorities to their workforce structure are better prepared to make strategic decisions on which positions should be contract employees, which positions should be full-time employees and which functions should be outsourced to third parties. In the Canadian oil and gas sector, contractors have become ingrained in organizations, fulfilling roles that should be performed by an employee for governance and economic reasons. Contractors are typically paid higher wages and allow limited opportunities for knowledge transfer. Progressive companies are transitioning contractors in key positions from contractor status to employee status while maintaining their best contractors, reducing overall wage bills and tax liability.

Rate cards:
In a similar approach as Category Management, companies should review the contractual rates they pay for different contractor positions and services. After a review, companies often find inconsistencies and have several suppliers who provide the same service staff but are on different rates and charge different mark ups. Companies can better manage costs by reducing expenses in this labour category; added benefits include setting up standard job descriptions, pay grades, reduced tax liabilities and a streamlined process for hiring high quality contract resources. In many cases, setting up a vendor management technology solution can assist in simplifying this process.

These strategies form part of an overall talent management and workforce strategy. By creating visibility, reducing overlap and establishing clear contract rate cards, companies will likely see reductions in third party contractor spending. Companies that have implemented these strategies have been able to reduce spending in this category by up to 25%.
Key performance indicators:
The role of KPI’s has been mentioned in many management books with the idea that the mere act of measuring operations and making the results visible generally drives improvement. The overarching principle remains that KPI’s should be aligned from the top to bottom of an organization and the focus should remain consistent for meetings, project goals and company milestones. If the focus of KPI’s is different at each level of decision making, there will be a disconnect within the company on the important factors driving projects and the tools to measure success. The more strategic companies look at all KPI’s across the business and rationalize them to match their core business drivers and priorities to create focus on these areas.

Value view:
The concept of structured and regimented processes sometimes causes an allergic reaction with employees, but there is a need for standard processes. It is not just important to have a process established and documented, but to make sure the process is looked at critically. One of the best tools to analyze a process is “value stream mapping,” which analyzes all activities in a process and classifies them as those that add value and those that do not add value. When analyzed, companies will often realize that more than 65% their work processes fall under the non-value added activities heading. Such wasteful steps typically fall into the following categories: unnecessary transportation, inventory, motion, time spent waiting, overproduction, overprocessing, defects and untapped human potential.

Some energy companies have created internal continuous improvement teams that have taken the first steps in examining and restructuring processes inside their organization. By focusing on productivity, energy companies have an opportunity to be more efficient and contain costs, while also operating in a safer and more environmentally friendly way.

3. Productivity

The increasing global demand for natural resources and the tight labour market in Western Canada are forcing energy companies to do more work with less people. Being a Lean company is more than just having fewer people and having them work harder. Lean businesses look to eliminate waste from their processes by making work simpler, safer and more efficient for their employees.

Many companies in the local energy industry have grown through steady streams of mergers and acquisitions. In the process they have collected a legacy of silos and unique cultures that if harnessed correctly could provide the organization with the expertise to create world-class operations. If not managed properly and standardized, this wealth of knowledge and diverse experience could lead to inefficiencies that impact all processes.

One benefit of standardization that is often overlooked is its role in continuous improvement. The systematic “elimination of all waste” preached by Toyota’s lean philosophy can only be applied once standardized processes are in place. Efforts spent trying to improve a process that is not in place, or that is not well understood, will not create sustainable increases in productivity.
Proper planning and management in the initial stages of projects will not only help reduce costs over the life of the project, but also increase accountability.
Looking forward

The Canadian Association of Petroleum Producers estimates more than $50 billion of annual investment is needed to continue developing Alberta’s oil sands, as well as emerging tight oil and shale gas formations across Canada. These unconventional reservoirs have aided the domestic industry in becoming one of the world’s five largest energy producers.

The abundant natural resources put Western Canadian oil and gas companies in an enviable position, but there is considerable financial risk in accelerated growth programs. Many energy companies are beginning to focus more on costs rather than sticking to rigid project schedules. This trend was highlighted by Suncor Energy Inc. in its 2013 capital spending plan. Canada’s largest oil and gas company noted that 2012 was spent focused on disciplined and prudent spending. “We will continue to maintain a relentless focus on operational excellence and reliability,” said Steve Williams, president and CEO of Suncor.

There are several operational areas where companies can improve cost efficiency. The three areas highlighted in this document are just part of an overall strategy to manage projects in a cost efficient, repeatable and sustainable fashion. Companies that can implement strategies to contain costs will be able to attract capital and remain competitive, both in Canada and globally.
Contacts

National Energy Leader
Reynold Tetzlaff
+1 403 509 7520
reynold.a.tetzlaff@ca.pwc.com

Partner, Consulting & Deals
James McLean
+1 403 509 7535
james.mclean@ca.pwc.com

National Marketing Specialist, Energy
Crystal Chong
+1 403 509 7555 ext 3019
crystal.chong@ca.pwc.com
Join the conversation

www.pwc.com/ca/energy-linked