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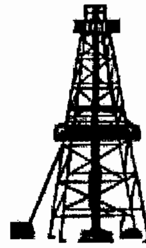

SPECIAL REPORT

ALLIANCING: A PARADIGM IN TRANSITION, GETTING THE INCENTIVES RIGHT

By Peter D. Loftspring

Part Two: Alliancing: A Paradigm in Transition

Editor's Note:

This series of articles is based upon a paper presented by Mr. Loftspring at the "Partnerships, Contracting & Strategic Alliances" Conference presented by the Strategic Research Institute in New Orleans on February 26-27, 1997.
Last month's article presented an overview of the Alliance

Paradigm. In this month's discussion, Mr. Loftspring looks at the changes in the Alliancing Paradigm.

ALLIANCING -- A PARADIGM IN TRANSITION

The role of the supplier/supplier alliance in the oil and gas industry cannot be underestimated in the coming years. As the industry's knowledge base continues to grow and the technologies available for oilfield applications become ever more sophisticated, the array of supplier offerings will both expand and become ever more complex. Indeed, the rate at which technological improvements are introduced continues to accelerate, creating fundamental changes to the entire industry (*e.g.,* the

state-of-the-art $10,000,000 supercomputer of just ten (10) years ago that was required to process massive amounts of seismic data is being replaced by desktop workstations that all but the very smallest firm can afford). Not only will new challenges require ever more advanced (and expensive) research and development, but the skills required to implement these new developments are constantly evolving and changing. Cost effective use of powerful new tools and their progeny will require experienced personnel with a broad understanding of not just the underlying technology, but also the supplier's ability to modify and enhance the tools as well as the customer's application of the tools.1 It is for precisely these reasons and the reasons discussed below that this new era demands ever tighter integration between supplier and customer. The remainder of this series of articles, therefore, focuses on oil and gas industry supplier/customer alliances, their (relatively brief) history, potential benefits, proper and improper application, and guidelines for creation.

Evolution of the Alliance in the Oil Patch

The increasing popularity of the alliance in the oil and gas industry is attributable, in part, to the Total Quality Management ("TQM"), restructuring and outsourcing trends of the mid 1980's and early 1990's. Just as these management tools were being introduced at the beginning of this period, the industry began to experience significant upheaval. Soft prices and weakened demand caused the producer community to contract drastically, leading inevitably to a reduced need to explore and drill for new reserves. Producers pared their staffs to maintain only the most essential functions required to marshal their existing reserves for sale and new exploration and drilling programs were cut dramatically.2 Following this staggering industry downturn, the push to become more profitable combined with the lack of trained, experienced personnel naturally lead producers to explore these increasingly popular new strategies.

These innovative management tools began focusing on quality improvement and the development of core competencies. Meanwhile, successfully re-engineered companies were beginning to demonstrate that the proper use of outsourcing could lead to noticeable improvements in the bottom line.3 As service companies began to appreciate that producer commitment to outsourcing meant significant new opportunities, the service industry also began to restructure. During this same period, both oil companies and service companies began to better understand the tenets propounded by TQM's emphasis on achieving the highest quality for the lowest overall resultant cost. New types of business arrangements evolved with this shift in focus and a number of early efforts at alliancing and partnering took place. The industry began to realize that service companies could supplement the oil companies' missing expertise if they were appropriately organized. Unfortunately, however, many of the early alliancing and partnering relationships were formed for the wrong reasons and ended prematurely.4 As discussed in more detail below, inadequate alignment contributed to a number of the problems, as price and volume were the only aligning characteristics achieved. Partly due to inexperience, this overriding concern to lower implementation costs did not allow the parties to focus on long term gains and the benefits achievable from close interaction throughout the entire project life cycle.

Following naturally from the movement toward outsourcing, the alliance relationship can be viewed, in part, as an "enhanced" outsourcing arrangement. Thus, like outsourcing, the relationship strengthens over time as communication improves and

trust is enhanced. Significantly, both outsourcing and alliance arrangements permit companies to expand their capabilities quickly and efficiently to accommodate rapidly changing market conditions. While the additional resources and expertise may come at a higher perceived initial cost than internally sourced expertise, effective utilization permits rapid improvements in a producer's return on investment and enables the company to develop its inventory of prospects in a much more timely and cost effective manner.5 Improper use of these resources, as demonstrated by some companies' attempts to outsource certain operations (*e.g.,* certain attempts at computer asset management), can lead to significant problems. It is therefore enlightening to understand the drivers behind successful outsourcing efforts to further appreciate the benefits of alliancing.

Outsourcing Objectives

In its 1995 Trends Report entitled "Outsourcing Purchasing Dynamics, Expectations and Outcomes," the Outsourcing Institute ("Institute") noted that overemphasis on short-term benefits is a clear warning sign of an outsourcing project that will prove unsuccessful. For either relationship to be successful, management must have a clear set of goals and objectives in mind from the start. When the strategic reasons for outsourcing are overshadowed by short-term business concerns, companies are often disappointed with the results. Outsourcing is a long-term strategic management tool. Through a series of studies conducted since 1991 (including surveys of over 1,200 companies), ongoing work with its members, and ongoing reviews of other major studies, the Institute has compiled a list of common elements that describe successful reasons companies outsource and the potential benefits to be gained. As a service to its members, the Institute has developed the following list of reasons for outsourcing:6

- ***Resources Not Available Internally***

Outsourcing is an important option when a company does not have access to the

required resources within the company. Where the required resources would otherwise need to be built from scratch, outsourcing becomes a viable and attractive alternative. Similarly, rapid growth or expansion of operations is a strong indicator that outsourcing may be right for a company.

- ***Reduce and Control Operating Costs***

Access to the outside supplier's lower cost structure, which may be the result of a greater economy of scale or some other advantage based on specialization, is one of the most compelling tactical reasons for outsourcing. Companies that try to do everything themselves may incur vastly higher research, development, marketing and deployment expenses.

- ***Make Capital Funds Available***

Outsourcing is a way to reduce the need to invest limited capital funds in non-core business functions. Instead of acquiring the resources through capital expenditures, they are contracted for on an "as used," operational expense basis, thus making capital funds more available for core areas. The tremendous competition within most organizations for capital funds makes deciding where to invest these funds one of the most important decisions that an organization's senior management is called upon to make.

- ***Free Resources for Other Purposes***

Every organization has limits on the resources available to it. The constant challenge is to ensure that its limited resources are expended judiciously in the most valuable areas. Outsourcing permits an organization to redirect its resources from non-core activities toward activities which have the greater return such as the exploration, acquisition and production of new assets. Frequently, the resources redirected through outsourcing are personnel resources. By outsourcing non-core functions, the organization can redirect these people toward greater value-adding activities.

- ***Share Risks***

Tremendous risks are associated with investments an organization makes. Outsourcing makes a company more flexible, more dynamic, and better able to change to meet changing opportunities. Markets, competition, government regulations, financial conditions, and technologies all change extremely quickly. Keeping up with constant change, especially where each next generation requires a significant investment of resources and dollars, is very difficult and "bet your company" types of investments are all too common.

Outsourcing is a vehicle for sharing these risks across many companies. Suppliers make

investments not on behalf of just one company, but on behalf of their many clients. By sharing these investments, the risks born by any single company are significantly reduced. Outsourcing is, in effect, the tool for becoming a more agile competitor.

- ***Improve Company Focus***

Outsourcing lets the company focus on more important business issues while having operational details assumed by an outside expert. Proper utilization of outsourcing can become an organization-shaping management tool which can lead to a clearer, more effective focus on expanding the company's prospects.

- ***Access to World-Class Capabilities***

By the very nature of their specialization, outsourcing providers can bring extensive world-wide, world-class capabilities to meeting the needs of their customers. Just as their clients are outsourcing to improve their focus, these vendors have honed their skills at providing the services in which they specialize.

Often vendor capabilities are the result of extensive investments in technology, methodologies, and people -- investments made over a considerable period of time. In many cases, the vendor's capabilities include specialized industry expertise gained through working with many clients facing similar challenges. This expertise is ultimately manifested in extremely well developed skills, processes, and technologies that can be brought to focus on problems that the customer organization has never previously encountered.

Outsourcing with a world-class supplier can offer the following advantages:

- Access to new technology, tools, and techniques that the organization may not currently possess;

- Avoidance of the cost of chasing technology and training associated with each new generation;
- Ability to concentrate on building new and improved capabilities that meet business requirements rather than managing current operations;
- Fewer operational problems due to the more structured methodologies, procedures, documentation and more experienced staff typically available with larger, well organized vendors;
- Competitive advantage through expanded skills;
- Access to better tools for estimating the costs of new solutions; and
- Access to industry knowledge and expertise the provider has gained from other clients/partners.

Outsourcing v. Alliancing - Significant Differences

More than ever before, companies in a wide variety of industries are beginning to realize that if they are to survive, let alone prosper, they must share costs, skills, capital, information, technology, access to markets, and, most of all, control of new and expanded business ventures.7 While outsourcing enables a company to avail itself of many of these key elements, the relationship is generally focused more toward institutional inadequacies of the host company rather than uniting the companies to advance marketing efforts, common product development, and enhanced customer solutions. Although the distinction between outsourcing and alliancing can blur where companies outsource certain key components of their product or service offerings, it is usually the commercialization of the arrangement that provides the distinction. Notwithstanding the fact that incentivization schemes are often used to align the parties' interests under both outsourcing and alliancing arrangements, alliances generally involve a higher level of commitment and broader range of integration between the organizations. Thus, for example, where a cementing company works closely with and relies upon a third party cement manufacturer for all of its products, a (loose) form of outsourcing arrangement has arisen; but where the companies work extremely closely together to develop new products, installation procedures and ways to market to each others' clientele, then the relationship is closer to an alliance.

Obviously, where the relationship depends upon one company to provide only a relatively narrow range of expertise to relieve the other company of a specific functionality, the relationship is clearly characterized as outsourcing. Conversely, where the companies work together as co-equals to bring management and engineering talent, cash, products and markets together, an alliance relationship can be said to have formed. The outsourcing relationship typically lends the most significant commercial advantage where each company desires to remain focused on its own core competencies and these areas of expertise do not overlap or compete. In some instances, however, the relationship between companies can take on either or both forms, depending upon the type of work performed. Thus, the relationship between a producer and a service company can be construed as outsourcing in instances where the service company provides in-house completions, engineering expertise; and, if appropriately commercialized (*i.e.,* proper incentives and risk allocations implemented for alignment) as an alliance where the companies work together to implement the solutions proposed by the engineer.

1*Definition of Strategic Alliances and the Alliance Process,* Marcar Management Institute of

America, Inc., (http://www.marcar.com/alliance_guide.html).

2Chandler, *Alliances, Integrated Services, and Partnering in the Oil and Gas Industry: Some Legal Considerations*, 46 OIL & GAS L. & TAX'N (1995).

3*Booth, Two Grandmasters at the Extremes, THE ALLIANCE ANALYST (http://www.allianceanalyst.com/grand.htm#top; November 25, 1995).*

4*Solutions for the 90s and Beyond, Alliances & Partnering Handbook*, Halliburton Energy Services, Inc., 1994.

5Quinn, *On the Edge of Outing,* THE ALLIANCE ANALYST (http://www.allianceanalyst.com/outing.htm#top; June 26, 1996).

6*The Top Ten Reasons Companies Outsource,* The Outsourcing Institute (http://www.outsourcing.com/topten.html, January, 1996).

7*Strategic Alliances in High Technology,* Susan Jacobini & Kathleen Mccreary, KPMG Peat Marwick (http://www.herring.com/mag/issue12/high.html; July, 1994).

Next month: "Considerations for the Alliance of the Future"

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