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Competitive advantage through alliancing*

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INTRODUCTION

Since 1990, BP Exploration Europe has been developing a significant track record in substantially reducing the costs of new oil and gas development projects. This is allowing fields which were once highly marginal to be transformed into attractive investment opportunities and has opened up the prospect of a future in the North Sea stretching well into the next century. At the same time safety and quality standards are being maintained or enhanced, and the design and construction contractors, as well as suppliers of materials and equipment, are sharing in the success by attaining enhanced levels of profitability.

A fundamental shift in the nature of the relationships between client and contractors lies at the heart of this transformation – a shift which has seen all parties put aside their previous adversarial approach to each other and, instead, pool their skills, expertise and resources to find creative solutions which allow their individual business goals to be achieved.

Underpinning this are so called 'alliancing' contractual arrangements. These are specifically designed to align the business objectives of client and contractors, to promote efficiency in all activities and at all interfaces, to ensure that risks are shared in a balanced, equitable way and to link rewards firmly and clearly to the outcome of a project as a whole. Alliancing is also affording those companies which participate, the incentive and opportunity to improve their own individual competitiveness to levels which enhance their ability to access the global market. The principles involved can be adapted and applied to any industrial sector to give access to radically improved performance and competitiveness.

BACKGROUND

By the latter half of the 1980s, BP Exploration Europe (BP XEU), along with many other operators, had recognized that reducing costs both of existing operating fields and of new developments was a prerequisite to the continued economic exploitation of the North Sea's oil and gas reserves and indeed, to the survival of the North Sea oil and gas industry. The high cost environment was such that the prospect of oil companies investing significant sums in new devel-

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opments beyond those already committed was regarded by many as unlikely, particularly given the competition for investment funds from oil provinces elsewhere in the world.

Faced with this situation, the operators' initial response was to put a great deal of effort into articulating the need to reduce costs, with particular emphasis being placed on imparting this message to the contracting and supply industry in the expectation that this would lead to costs being driven down. Coupled with this was a drive to find technological solutions and the introduction of contractual arrangements such as EPC and EPIC, all of which were regarded as offering routes to reduced costs to the operators.

The results achieved were less than had been hoped for and, with the benefit of hindsight, that was perhaps predictable. It was equally clear that, whilst technological advances could help, they alone were unlikely to produce the step change in costs that were urgently required, and contractual approaches such as EPC and EPIC were being seen as offering, at best, a means to contain costs rather than reduce them.

By the beginning of the 1990s, therefore, some operators had recognized that a different approach was required if their goal of reducing costs was to be achieved, and they started examining how the culture and attitudes of their own organizations and personnel might be an inhibiting factor. In the case of BP XEU this revealed that, for the most part, contractors and suppliers were held in low esteem, the overwhelming attitude was that BP knew best and not only had to define its requirements of contractors and suppliers in fine detail, but also had to employ large teams to monitor and check them at every stage.

Of course there were many (valid) reasons why these attitudes and practices had developed over the years, but it seemed clear that they were at the root of high costs. This view was confirmed from the responses given by a wide cross section of contractors and suppliers to an open invitation to describe what it was like to do business with BP XEU. A number of common features of BP XEU's relationships with contractors and suppliers, seen as contributing to high costs, were identified, including:

- Lack of recognition and ineffective utilization of contractor/supplier skills
- Risks placed on those unable to influence or manage them
- Conflicting business goals
- Overprescriptive and onerous client requirements
- Lack of clarity of accountabilities
- Short term and adversarial.

These were all considered to characterize a master/servant type relationship and to be a major source of unproductive costs through the inefficiencies they were seen to engender within individual organizations, at the interfaces between companies and through the duplication of effort across companies. In addition, the nature of the relationships was such that ideas for innovative approaches and improvement to reduce costs, from contractors and suppliers, were being stifled.

The clear message received by BP XEU was that if it was serious in its intent to

achieve lower costs, then it would have to be willing to develop and implement new forms of relationships with its contractors and suppliers which addressed the shortcomings that had been identified.

The then existing forms of relationships between North Sea operators and their contractors and suppliers had evolved over a considerable period. Whilst both sides considered them to be unsatisfactory, patterns of behaviour had been established on both sides which were deeply entrenched and presented real barriers to setting up new relationships. So whilst it was self evident that new relationships would ultimately have to find expression in contractual terms, it seemed clear that the key to success initially lay in finding ways to break down these barriers and encourage and foster appropriate new behavioural patterns. BP XEU, as the client, also saw that it would have to provide a lead but that it was important that this was done in a way which clearly demonstrated BP XEU's integrity, was non-prescriptive and allowed contractors to participate and contribute as equals in the process so that all parties would develop full ownership of the end results.

These basic principles have subsequently been applied in developing relationships across a range of activities, both for existing operating fields and for new green field projects. This has led, through a process of evolutionary learning, to what have become known as alliance relationships, which are discussed further below with particular reference to alliances formed to undertake new projects.

ALLIANCE PRINCIPLES

The dictionary defines an alliance as 'a union or association formed for mutual benefit'. In the context of undertaking a new development, the aim is to construct an alliance whose members will typically be the client and the key contractors who can most directly influence the outcome of the project, and who will then work together to deliver the project and share in the benefits of doing so in a more efficient way.

From what has been learned to date, BP XEU sees the main principles that should be included in any alliance arrangement as:

- A primary emphasis on the business outcome for all parties
- A commercial basis which offers the opportunity to achieve rewards commensurate with exceptional overall performance measured against clear predefined targets and in which risks and rewards for the parties are equitably balanced
- Individual and collective responsibilities and accountabilities clearly understood and defined
- Access to and contribution by the expertise and skills of all parties
- Openness and co-operation between the parties
- Encouragement to develop and apply innovative approaches and achieve continuous improvement.

Business outcome

The importance of the business outcome for all parties needs to be fully acknowledged and the alliance focused on achieving a 'win' for everybody. A 'win' for the client will certainly include a lower cost for the project but may also include other factors pertinent to the specific project. For the contractors a 'win' will usually be measured by enhanced profitability but again other factors may also apply. The important thing is that jointly determining the factors is vital in setting a context for achieving alignment of goals.

Commercial basis

The primary incentive for parties to enter into an alliance is the possibility of gaining enhanced rewards. A key factor in the alliancing arrangements is that, where possible, rewards are geared to the outcome of the project as a whole and are not dependent solely on the performance of the individual contractor. It is therefore extremely important that the parties to the alliance jointly develop and agree the targets around which the risk and reward structure is to be based. This requires an unusual degree of openness between the parties. For example, each of the parties has to be willing to share with the others the detail underlying their portion of the costs.

Of course, achieving enhanced rewards cannot be a guaranteed outcome and there will always be a risk that the reverse will apply. It is also worth noting that any enhanced rewards that are on offer should not derive from the operator transferring inappropriate additional risks to the contractors. Only those risks which are related to the scope of the specific project should be taken into account.

There are two specific principles relating to risk which are paramount in achieving an equitable arrangement. First, none of the contractors who are party to the alliance should be expected to expose themselves to a commercial outcome that would endanger the future of their company. Second, the risks inherent in any project undertaking should be jointly identified, properly understood and fully articulated. It will then be possible to agree which party or parties should have prime responsibility and accountability for managing particular risks, and to develop a structure which balances the rewards with the risks.

Responsibilities and accountabilities

It has always been the case that contracts have defined responsibilities and accountabilities, or at least attempted to do so. However, there is an additional dimension to this in respect of alliances in the sense that each party will now have obligations to each other. Having each party understand this and have a proper regard to discharging these obligations is an essential part of achieving a successful outcome.

Skills and expertise

In developing an alliance relationship an essential first step is for the client unreservedly to recognize and acknowledge the skills and expertise base available within contractors. Mobilizing these skills and resources to create additional value to the benefit of all the parties is a key issue in constructing an alliance arrangement. The desired end result is to put together a structure for implementing the project which is truly integrated and in which there is no duplication of functions, responsibilities and accountabilities. For most clients this represents a fundamental shift from their previous *modus operandi*, which was based on keeping contractors at arms length whilst at the same time monitoring and to some extent controlling the contractors' activities and outputs. It is a shift, however, which is essential if the potential benefits of alliancing are to be gained in practice.

Openness and co-operation

This is one of the so called softer aspects but, nonetheless, it lies at the heart of alliancing, and the importance of engendering truly open and co-operative behaviour by all cannot be over emphasized. It is an essential prerequisite, without which the chances of achieving a successful outcome will be more dependent on luck than on design. It is an area in which the client has a significant part to play in creating an atmosphere in which the contractors do have the freedom of expression which will allow them to make meaningful contributions to the goals of the alliance.

Innovation and continuous improvement

The essence of alliancing is to reduce costs and increase profitability for all, without sacrificing safety or quality. Achieving this is dependent on all of the parties finding ways to make the whole implementation process more effective. In turn, this requires that all of the parties continuously examine not only their own activities but those which involve interfaces with others, with a view to eliminating unnecessary activities and finding ways to execute more efficiently those which remain. The alliance commercial basis referred to above should also be constructed in such a way that it promotes such processes, even to the extent of encouraging one party to transfer activities to another if that offers an improvement.

SOME PRACTICAL CONSIDERATIONS

This section addresses some practical aspects of establishing an alliance incorporating the principles described in the previous section. These include the contractual framework, including the management structure and the selection of contractors.

Contractual framework

Careful thought needs to be given to the contractual and agreement framework to be adopted for alliancing relationships, and it is as well to appreciate that there is probably no single correct model. The important principle is that the contract structure and terms should be designed to support the desired business outcome and relationships, rather than the reverse. It should also be recognized that, ultimately, the key to success is more likely to be found in the way the parties work together than in the way the contracts between them have been drawn.

One particular issue which has to be addressed is the choice between incorporating the alliancing commercial basis within the individual contracts with contractors for the provision of their services, or putting them in a separate alliance agreement to which the client and contractors are all party, or indeed by some other means. Irrespective of the choice made, the question of how the contractors are to be directly paid for the services they are providing has to be addressed. Given the nature of alliancing and its intentions, it is clear that some form of reimbursable approach is required and it could be argued that a totally 'open book' approach would be the ideal. However, it is important to recognize that this will not always be possible and flexibility will be required.

Sharing of risks and rewards

There are several possible approaches as to how gains and overruns are to be shared between the parties to the agreement, of which perhaps three are most favoured. These are that each party's equity stake is proportional to one of the following criteria:

- Ability to influence outcome
- Value of services being provided
- Total money put at risk.

Each approach has its merits and so it is not surprising that this topic can generate much time-consuming debate among the parties. However, given its importance, this is time well spent as reaching full alignment on this matter is crucial.

Management structure

The management structure for implementing the project is of particular interest to the contractors who, with arguably more to gain and lose, wish to take a more direct role in managing the project as a whole than they have done under more conventional contracting arrangements. Equally, the client (including co-venturers where applicable) is concerned to ensure that the alliancing approach does not erode their ability to influence and control matters that have a critical bearing on the outcome of their investment. The perceived wisdom is that somehow these interests are in conflict. However, a few moments thought soon reveal that the key fact, and one that is often overlooked, ignored or even totally discounted, is that all of the parties stand to gain from a low cost, well-executed

project. Having all the parties recognize and acknowledge this is an important first step in building effective management structures and controls.

Two specific management structures have been set up for BP XEU alliances – an integrated project management team (PMT) and a so-called Alliance Board (AB). The PMT, comprising the project managers of all of the contractors, is led by the BP project manager and is directly responsible for the implementation of the project and the management and administration of all of the works contracts. The AB, comprised of a senior management representative from each of the alliance members, is responsible for administering the alliance agreement itself and, more importantly, for providing guidance and advice to BP as the client and to the PMT in the implementation of the project.

BP XEU see the concept of an AB as being at least equal in importance to a truly integrated PMT, and potentially much more influential than a description of its responsibilities might imply. This importance lies firstly in the fact that, whereas previously the client had to rely principally on their own resources in managing projects, a much wider, and arguably more pertinent, pool of knowledge is now accessible. Second, it affords the contractors a forum in which their senior management can put forward their ideas for improvement, with the guarantee that they will not be brushed aside as has so often happened in the past. What is more important, it offers them an opportunity with the client to raise their level of thinking and contribution to project management to a higher strategic level, and to open up a real possibility of radical performance improvement in all aspects of projects, with consequential benefits for all the participants.

Selection of contractors

There are three aspects of selecting contractors which need to be given consideration: first, which contractors, second, the timing of their selection, and third, the method by which they will be selected.

Which contractors should be invited to form an alliance will depend on the specific project, but the principal criteria should be their ability to influence the final outcome. For the most part this will be related to their ability to influence the final cost, but for some projects other criteria may carry equal weight. Traditionally, contractors have been selected at a relatively advanced stage of design of the project and almost invariably after the project has been financially sanctioned by the client. For the alliancing approach there is a strong case for involvement of the contractors at a much earlier stage, both to allow them to make a contribution to developing the case for sanction and to allow the detailed alliancing arrangements to be put in place as part of the sanction case.

With regard to selection, it has also been the traditional approach to select on the basis of competitively tendered bids, with price being by far the most important and, in many cases, the sole criterion. However, it has been BP's and others' experience, that bid price is not a particularly reliable indicator of final cost and that there are many other factors which have a bearing on the final outcome.

In the case of alliances it can be argued that some of these, principally the so-called soft technology or behavioural factors, are likely to be even more important and that the selection process and the selection criteria should be designed to take these fully into account. In BP XEU's view, these factors are so important that frequently they are now given equal or greater weighting in selecting contractors for an alliance through processes that fully comply with EU directives.

PERFORMANCE

BP XEU's start on developing new approaches to working with contractors on new developments can be traced back to the Unity development completed in 1992. Whilst this was not set up as an alliance, it nevertheless saw the introduction of several important changes from BP's traditional approach to development projects, and some important steps in the process of promoting changes in working practices at the interfaces between the various parties involved.

Prior to Unity being sanctioned, the cost of the development had been estimated at £150 million, this being based on a 'business as usual' approach to project execution. The project was actually sanctioned at £115 million to take account of the estimated impact of some of the changes it was intended to implement. The final cost turned out to be £94 million, a result which reinforced the view that new approaches could pay handsome dividends.

Unity was followed by the Hyde development in which the concept of alliancing was first formally introduced. Hyde, a small gas field in the southern sector of the UK North Sea, was regarded as a highly marginal investment opportunity which clearly required development costs to be reduced significantly if it were ever to go ahead. In many ways, however, Hyde presented an ideal opportunity to develop further what had been learned on the Unity project. It was a relatively small project and, perhaps most importantly, the facilities required for Hyde were more or less identical to those which had been constructed for BP's Amethyst field. This latter point led to the idea that, by using the same main contractors, it might be possible effectively to utilize the combined experience of client and contractors to produce better results.

After some months of negotiation these contractors and BP developed a target cost for the development and a risk/reward structure based on the final outcome, which gave a sufficient basis for the project to be sanctioned. At the same time, BP together with the contractors had also entered into a formal agreement to undertake the implementation of the project as an alliance. In the event, the project was completed some 25% below the agreed target cost. This result was not only highly satisfactory from BP's point of view, but with the contractors taking a large share of the savings, their levels of profit were substantially above those they would normally expect.

Andrew, being a much larger development than Hyde with potentially more main contractors as well as being an entirely new development, presented new and different challenges when it came to constructing an alliance. Like Hyde,

however, it too required significant reductions in cost if it were to be sanctioned. This led to a major departure from BP's normal approach in that it was decided that it would be appropriate to select all of the main contractors prior to sanction, and to have them work together with BP jointly to develop the sanction case. In effect a pre-sanction alliance was formed which had as its common goal the sanction of the development. The prize for the contractors in achieving this was their involvement in the execution of the development, and for BP it was an opportunity to make a profitable investment for its future. This goal was successfully attained with the sanction cost being some 25% lower in real terms than would have otherwise been achieved. An exceptionally narrow range of uncertainty on this estimate was also achieved as the result of having base costs to which all the parties were committed, and a jointly developed understanding of the risks to these costs. All of this was underpinned by the formal alliance agreement between BP and the six main contractors involved, which ties the overall reward to the parties to the final cost and the final completion date of the project. The arrangement is such that the contractors between them will receive over 50% of any savings actually achieved against the agreed target cost.

The implementation phase of Andrew only started in February of this year, with completion targeted for the end of 1996. Already, however, there is tangible evidence that the alliancing approach is encouraging new levels of co-operation between all the parties, leading to cost and time savings. For example, the Alliance has been able to find around £10 million of savings and to bring forward the projected completion date by 2 months.

The Cleeton compression project has also been sanctioned and again alliancing has been a major factor in achieving sanction and will be a major feature of the project execution arrangements. In this case the alliance will include a major supplier for the first time and the risk/reward structure will not just be geared to the cost outcome of the execution phase of the project, but will also encompass various targets for the first 2 years of the fields.

CONCLUSION

BP has taken important steps in transforming the relationships between itself and its contractors in undertaking new development projects. The results being achieved give a strong indication that this provides major leverage in reducing the costs of developments whilst at the same time enhancing both the profitability and competitive position of the contractors who are involved. Similar results being obtained through alliances for various activities on producing field reinforce this view.

Whatever progress has been made, it would be a mistake to believe that there is nothing more to learn and that a detailed recipe has been developed which, if rigorously applied, will guarantee success. The process is continuously evolving to design the right alliance for each project. What has become clear, however, is that it is in the behaviour of and relationships between individuals and companies

where the keys to achieving competitive edge can be found, and that support from the highest levels of management is needed to get alliances started and to keep them working.