“How Low? How Long?”

Using Rapid Procurement Excellence to Capitalize on the Downturn

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Rapidly plunging oil prices surprised the global oil & gas industry. The entire industry is debating the question “How low will prices go, and how long will this last?” with views ranging from short term (less than 6 months) to a sustained “new normal”. This high degree of uncertainty is unsettling. Many believe that it is OPEC’s objective to restructure supply and eliminate some Light Tight Oil players. However, shale gas, Light Tight Oil’s older brother, has been amazingly resilient, continuing to grow even after gas prices plummeted from $12/MMBTU to less than 3.

Regardless of how long prices maintain at current levels, the implication remains the same – companies will likely be short on cash and need to drastically reduce spending to meet obligations. The crisis also provides the “case for change” for companies to transform their spend base and leverage the crises to unlock value, both short and longer term. In our experience, the most expeditious way to do this is through rapid procurement excellence.

Capitalizing on the downturn

At $50/barrel (at the time of this article), almost all operators will struggle to meet cash flow obligations. Our analyses shows that the most vulnerable upstream players will have to cut CAPEX up to a staggering 30-50%.

Throughout the value chain, companies will need to ensure their economic viability by focusing stringently on cash, radically reducing costs, and bolstering project delivery.

The drop in price provides a rare opportunity as:

- demand for equipment and services drop, creating a “buyers’ market”
- supplier oil-linked pricing and value-based pricing mechanisms re-price lower to reflect lower oil prices
- a forcing mechanism to break the cost escalation trend of the last decade

Many companies will first aggressively slash CAPEX budgets or freeze spend categories (e.g., only mission-critical travel) before tackling procurement. While these are effective at generating immediate cash, they are often short-sighted, either sacrificing future production or being hard to sustain.

Future winners will successfully reduce spending across all parts of the business without sacrificing future production, operations or quality/HSE. A rapid and focused approach on procurement excellence can deliver quick ramp-up, with 25-40% of identified savings realized in year one and incremental 50-70% of identified savings realized by end of year two. Plus, a 1% reduction in spend through procurement excellence can yield a 5% bottom-line improvement to the business.

This is cash that can be put to work immediately to weather the downturn and allow for targeted investments as other companies are forced to part with assets.

Think beyond traditional procurement

Seizing this opportunity requires a different, and probably new, approach as companies need cash now and there is a clear “first mover advantage”. We recommend learning from restructuring and private equity, where companies take an aggressive and targeted approach, challenge existing paradigms, and execute relentlessly:

- **Nothing should be off limits:** Be prepared to open up all contracts and go back to the market. Consider the full spend cube (category, location, supplier) and quickly identify targeted areas that yield the most cash. Maintain a wide aperture and assess non-typical spend such as contracted services, which can often be reduced dramatically with little impact on the operations.

- **Full leadership team puts "skin in the game":** Traditionally, procurement programs are driven by CPOs and may lack buy-in from the business. Consequently, procurement is rarely at the top of the agenda and decisions take a long time. In a downturn, it is important that senior business leaders commit to the program and ensure full organization support. Consider having CEO or COO play the role of "Chief Cash Program Officer".

- **Organizations need to be pushed beyond their comfort zone:** Set aggressive, top-down targets and incentives to create a sense of urgency and focus. The key is to rigorously track and monitor performance, holding a weekly cadence of meetings to assess progress against targets and quickly resolve issues that arise.

- **Time is of the essence:** Each day that passes without securing cost reduction forfeits savings and risks missing the opportunity window. Ramp up staffing and resources, including temporary assignments and external support as needed. It is imperative to launch parallel efforts, each consisting of a group of categories, which deliver fast impact. This enables covering 2-3 times more spend in the same time period.

Ways to drive impact

Based on our experiences, we identified a set of best practices and cutting edge ideas. These originate from our experience in similar price shocks across industries and fall into two groups: quick hits and end-to-end supply chain optimization.

Quick Hits: The objective is to unlock immediate cash flow via lower prices and discounts. This can be accomplished through a series of quick and targeted initiatives. The impact realized is directly linked to the number of initiatives, the size, and the rigor of preparation.

- *Convene top tier supplier summits* – Hold day-long summits with suppliers to develop cost reduction opportunities. Recently, a global steel manufacturer ran 20 supplier summits over a six-month period, generating 12% savings. The key to success was the 4-6 weeks of preparation for each summit, which included developing a deep understanding of supplier and market economics, detailed should cost models, rigorous negotiation preparation, and dry runs.

- *Rapidly re-price the tail* – For suppliers not addressed in summits, broad outreach programs are appropriate. Key activities range from rapid RFQs leveraging tools like e-auctions to sending letters to suppliers asking for cost reduction and payment terms extensions. During the 2008/9 recessions, this was widely used across industries generating, on average, 10-15% savings on addressable spend and up to a 3-4% reduction of total spend.

- *Look internally* – Large value can be realized by reducing usage of outsourced services and enacting more stringent internal policies on temporary labor, other indirects, etc.... Often these are quick levers to unlock short-term cash without disrupting operations. For example, an oil sands producer reduced headcount of multiple contractors by 5-50% through creating cross-functional "war room" teams and leveraging simple analytics (e.g., badge registry). They achieved lasting impact as they crafted the plan with business partners and developed an easy-to-follow process for compliance.

  In another case, a regional utility was able to reduce temporary labor costs by 40% (half from demand management and half from rate reductions) by developing a detailed understanding of what the business needed (versus what they wanted), making cost/benefit tradeoffs visible to decision makers, and enacting rate cards that eliminated costly and opaque price adders.

- *Embrace industry standards* - Narrow the range of specifications used, moving away from unique parts and equipment that often provide greater functionality than is needed or require custom manufacturing. A recent study on North Sea subsea equipment found that 75% of all specifications are unique to only one operator, yet none of these unique specifications were considered critical. At an oil & gas company, standardization created 20-30% value in offshore water pump packages by moving away from a customized model to using the “off-the-shelf” version with no discernible effect on quality.

End to End Supply Chain Optimization: Companies with solid balance sheets and significant cash stockpiles can use the crises as a trigger to redesign their supply chain and drive medium to long-term impact. One-time opportunities exist to fundamentally lower the cost of equipment and build a sustainable competitive advantage.

- *Challenge technical status quo* (Design to Value (DtV) and specification optimization) – As the industry may be entering a new normal of lower oil prices, companies will also need to figure out how to deliver the same equipment and services at a much lower cost. For example, an aerospace company reduced the cost to manufacture compact valves by 50-80%. On average, a 20-40% cost reduction is possible by optimizing designs to include re-evaluating functional requirements, changing materials, and using standards and modular fabrication.

- *Reengineer the value chain* - Explore new entrants within highly consolidated or single-sourced categories. Recently, a bauxite miner secured a ~40% discount from a monopoly driller by using the credible threat of bringing another driller into the region.

  Since supplier valuations are dropping along with oil prices, it presents a unique time to gain control over critical parts of the value chain. This can be done by either taking an equity stake or acquiring. Look for suppliers who have high margins or provide a critical product or service without many viable alternative sources.

Shifting spend to affordable quality suppliers in low cost countries (LCCs) generates high spend reduction. With the increased capabilities of LCC suppliers, a growing number of Oil & Gas companies have shifted their supply chain to LCCs without sacrificing quality of production. Consistent savings of greater than 30% have been observed in Oil & Gas and other analogous industries like Aerospace and Industrial Machinery.

Getting to impact

On the path forward, companies must determine which approach is best by clearly articulating their objectives, targets, and timing, then comparing the effort required to internal capabilities and resources. In our experience, there are three common ways we can help capture value during a crisis:

(1) Short-term cash optimization: Primary focus is on the quick hit levers listed above via a series of 4-8 week sprints (e.g., rapid re-pricing letters for all tail suppliers) and concurrent mini-waves of 10-12 weeks to address multiple large categories (20-30). McKinsey has supported clients on these initiatives through either targeted support (e.g., preparing fact packs and tactics for negotiation) or by deploying consultants to drive initiatives end-to-end. This approach is best when short term cash flow is needed through discrete efforts.

(2) High intensity transformation: Often referred to as a restructuring approach, this was developed in collaboration with private equity firms as a way to drive to high impact in minimal time for their portfolio companies. Recently, this approach was used successfully, delivering $2.5bn FCF impact over 5 years for the ongoing transformation of an offshore Oil & Gas operator. Here, the joint client and McKinsey team adopted a private equity mindset: cash is king, bias to action, and protect the equity. Also, this approach was used by a global mining company to reduce CAPEX by 37% without reducing production targets.

McKinsey has deep experience in helping clients replicate this level of value capture in our Restructuring and Transformation Service Line (RTS). With RTS, the working team drops the “nice to haves”, moves fast with 80/20 information, focuses on releasing cash fast, and finds ways to do more with less resources. We have served over 60 RTS clients in 2014, delivering billions in EBIT improvement. This is best for companies in a cash crisis and seeking drastic change and lasting impact.

(3) Strategic category optimization: This takes the traditional procurement approach and intensifies the focus on leveraging the crisis to radically change high spend, high supplier-margin categories. These are typically 1-2 year programs executed in waves of 3-5 categories, each wave lasting approximately three months. A comprehensive set of levers is used to capture both short and long-term savings, balancing impact with capability building. This is best used by companies with strong balance sheets who seek to extract maximum long-term value from the crisis and use it as a platform to launch a sustained transformation.

Aggressive action will be needed to capitalize on the recent price drop and be prepared for the next upturn. Each day that passes could amount to loss savings of $125k per day (based on $500M of spend)… Never let a good crisis go to waste.

If you would like to learn more about the ideas discussed or want to move to action, please reach out to the McKinsey procurement practice to speak with one of our many experts.