COMMENTARY

COMMERCIAL OPTIMISATION:

How to ensure full value capture from oil and gas value chains

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Marakon

Management Consulting at Charles River Associates

INTRODUCTION

The term "lower for longer," once just a catch phrase is now the accepted reality across the oil and gas industry. Integrated oil and gas producers across the globe have done a herculean job of cutting production costs to become profitable at lower prices, but now need to capture additional value from downstream assets. In an environment of increasing margin pressure, firms need clear frameworks and active processes in place to capture and maximise value from integrated value chains.

WHAT ARE THE DRIVERS?

In our work with clients, we observe a number of common issues driving lost margin across downstream value chains:

- Focus on "vertical integration" at the expense of "commercial optimisation"
- Too much emphasis and orientation on "internal drivers" and absolute performance vs. external drivers and relative performance
- No information about true "available margin" given fundamental constraints to the system
- Asset-focused thinking at the expense of "system" thinking
- A "backward looking" vs. "forward looking" performance management process
- Lack of senior management engagement

HOW DO FIRMS CAPTURE VALUE FROM DOWNSTREAM ASSETS?

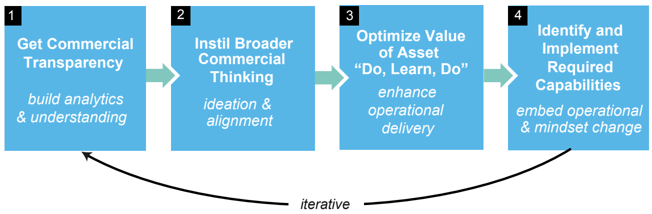
Consistently achieving full economic utilisation of downstream assets requires considerable organisational learning and development. Most firms are good at optimisation around a single asset, but risk leaving material value on the table as systems thinking is hard, and requires broader consideration of the external market, trade-offs across assets, and organisational boundaries. These trade-offs are evident in some of the questions firms should ask themselves:

- Is our equity crude more valuable to others than it is to us? If so, are there "cheaper" alternative sources available?
- What intermediate feedstocks are most valuable to the market given competitor configurations? How does that compare with internal value given own configuration?
- Where are the greatest "bottlenecks" in the market system and how can we exploit them given the current configuration? What are the implications for investing in new kit?
- Are all customers created equal? What distinguishes them and what are the trade-offs in serving some vs. others?

Building Blocks

We have identified four key building blocks to help firms build insight and capability over time to answer these questions and execute on the implications, which will lead to additional value capture.

Exhibit 1: Commercial optimisation framework

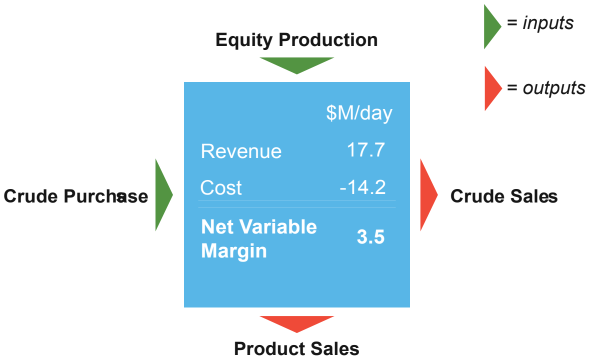


Source: Marakon

1. Get commercial transparency (build analytics & understanding)

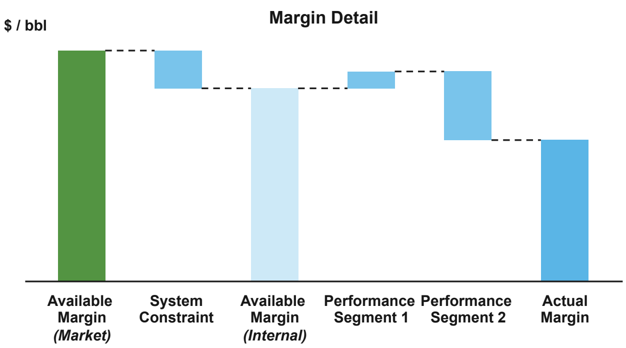
The first step to achieving commercial transparency across the full value chain is understanding how much value is available today. Market indexes, adjusted for structural constraints/advantages embedded in the asset configuration, can be used to map the value available in each asset, and across the full value chain. Actual financial performance is then evaluated on a monthly basis against the available value in the market to identify consistent trends. When mapping available value and evaluating actual performance, it is important to segment activities at a meaningful level to clearly identify where value is lost or gained. For example, when evaluating a refinery that consistently realises above-market input costs, it's important to be able to identify if the driver is poor crude selection, or if poor purchasing decisions are being made.

Exhibit 2: Map of product flows and captured margin (simplified)



Source: Marakon

Exhibit 3: Margin capture performance detail (simplified)



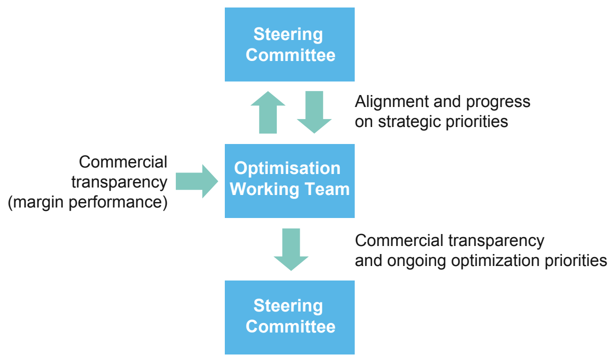
Source: Marakon

2. Instil broader commercial thinking (ideation & alignment)

To instil broader commercial thinking across the organisation requires creation of the right dialogues at all levels, with everybody looking at the same things. We have found the following approach helpful:

- Create a working team of senior managers from across the value chain whose role is to develop / prioritise commercial optimisation activities and assign clear accountabilities for delivery of those activities. The feedstock for the working team is the output from building block 1. Focus on the most material opportunities first, while also looking for quick wins to build momentum and buy-in. Where along the value chain is the most value being lost on a consistent basis? Where can we close the value gap most quickly?
- Earmark time every month in the executive agenda to review commercial optimisation performance and progress against the prioritised activities to ensure visibility at the right levels. Delivery accountability can be assigned by the working team, but ultimately the executive and business unit heads need to be aligned on priorities.
- Cascade reviews of margin capture performance and ongoing optimisation priorities down into the business units. It is often the people inside the business units / assets that have the least visibility of actual performance, especially across the full value chain. It's imperative they have visibility so it is clear why the optimisation priorities are such, and can support effective and timely delivery of those priorities.

Exhibit 4: Meeting structure and information flow



Source: Marakon

3. Optimise value of the assets "Do, Learn, Do" (enhance operational delivery)

Achieving full economic utilisation of the assets will not happen immediately. It is both an incremental and iterative process, which requires regular feedback through building block 1, to become "Do, Learn, Do". Performance should be consistently evaluated to confirm if the impact of optimization activities on realised margin is as expected. If not, activities can be re-prioritised, or altered as necessary. Incremental improvements can then be built upon to achieve material impact on overall value chain performance.

4. Identify and accelerate implementation of capabilities required to achieve sustainable improvements (embed operational & mindset change)

Ensuring the improvements made from the first three building blocks are sustainable often requires tangible changes to the governance and operating models.We have identified three key areas where that is often the case, but there can be others.

- Risk management framework: ensure there is clarity around which exposures the business naturally holds (e.g. own a pipeline spread), and which are being created through commercial activities (e.g. crude purchases), so that risks are managed actively rather than passively, even if that means keeping the exposure. This becomes important when trying to isolate drivers of performance from natural movements in underlying prices.
- Performance management framework: individual and team performance evaluations should be linked to the real drivers of value, performance vs. the market rather than performance against internal drivers or measures less directly tied to value (e.g. volume)
- Incentives: link the incentives framework to the commercially aligned performance management framework to ensure the right behaviours are being encouraged.

CONCLUSION

Commercial optimisation of downstream value chains has the potential to drive material value capture and, ultimately, significant improvement in firm performance. There are numerous levers to pull re: trade-offs (e.g. product specification, target customers, capital investments on kit configuration), but clear frameworks and active processes are required for being clear about the trade-offs. We have identified four key building blocks firms can use as a framework to build an approach that works best for their needs. The result is a more dynamic and commercially oriented organisation capable of ensuring money is not being left on the table and value in downstream assets is not being lost.

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ABOUT MARAKON

Marakon is a strategy and organizational advisory firm with the experience and track record of helping CEOs and their leadership teams deliver sustainable profitable growth. We get hired when our client's ambitions are high, the path to get there is not clear (or taking too long) and lasting capabilities are as important as immediate impact.

We help clients achieve their ambitions for sustainable profitable growth through:

- Stronger strategies and advantaged execution based on:
    a. A better understanding of what drives client economics and value
    b. Insight into changing industry dynamics and the context in which clients need to succeed
- A stronger management framework to generate better ideas and link decisions and actions to value
- A stronger organization with a more focused top management agenda and well-aligned resources
- A more confident and effective leadership team that's focused, decisive, and strategic

We have a joint team delivery approach where client ownership and engagement is paramount. Partners are highly engaged in the work product and supported by strong analytical and industry relevant capability. We work as advisers and catalysts in close, trust-based relationships with top management teams.