strategy+business

ISSUE 65 WINTER 2011

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REPRINT 11402

This article was originally published by Booz & Company.

Illustration by Lars Leetaru

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by Gerard Paulides

For virtually every company, the need to manage costs is an imperative for sustained high performance. The need is especially acute now. After several recessionary years and a hesitant recovery, today's business environment leaves no room for error. Indeed, in the oil and gas industry, recent and long-term trends suggest a period of continuing uncertainty.

Demand for oil and gas is nearly impossible to predict, as industrialized economies revive in fits and starts and emerging economies mature, changing global trading patterns. Meanwhile, the supply side has its own question marks, as the impact of events like BP's spill in the Gulf of Mexico, the post-earthquake nuclear power plant accidents in Japan, climate change concerns, more stringent drilling regulations, and political turmoil in the Middle East add to the challenges and opportunities facing the oil and gas industry. Questions abound about where new energy sources and reserves will be found, and what the future energy mix will look like.

Given these industry conditions, companies that fail to deftly manage revenue and costs will find themselves vulnerable to market and price fluctuations that are often out of their control. Consequently, in early 2010, Royal Dutch Shell PLC's European Upstream leadership team decided to pursue a significant improvement in its cost structure, one that would have a substantial impact on the company. We defined *having a substantial impact* as lowering the cost budget by 30 percent. In fact, the only aspect of our business that was off-limits was what we call HSE, or health, safety, and the environment; to achieve top performance in our industry, we must protect our workers and assets and the environment around them. Uncompromising HSE management is a prerequisite.

It was obvious to me that traditional continuous improvement and lean efforts, many of them already widely adopted by Shell, would not be sufficient to meet the high expectations we had for our European business. I see continuous improvement in a big corporation as necessary in what I would call managing cost creep: reducing the 3 to 5 percent in additional costs or waste that most large companies seem to generate every two or three years. But continuous improvement alone wouldn't do this time; we wanted a "hard reset" to make a significant difference. We wanted to achieve a real step change in cost levels and, more importantly, in the company's approach to cost management.

To establish the program, the executive vice president for Europe (equivalent to a CEO) and I (a CFO for exploration and production operations in Europe) put our full weight behind the initiative from Day One, by communicating the importance of resetting our cost base and spending behavior throughout the organization. We characterized it as a way to allow our teams to explore new revenue opportunities. We described cost reduction as a priority that was as important to our business as oil and gas production and hydrocarbon maturation. We articulated both the size of the cost management effort that we wanted and the timing (2011 through 2013). Moreover, we backed up our new cost estimates with benchmarks, such as unit cost of production, to illustrate our current performance, and where we could improve relative to our competitors and the top quartile in our industry.

We and the wider leadership team involved in exploration and production of oil and gas in Europe put substantial resources behind this cost management campaign. We created two multifunctional teams made up of our most talented staffers — handpicked from a wide array of company functions, including technical, production, commercial, and finance — to identify cost opportunities and develop implementation plans. We freed these staff members from their day-to-day work for five weeks to spend 100 percent of their time identifying realistic cost management opportunities.

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Often, when there is a special project, you go around the organization and ask, "Who is available to work on it?" But we felt that this effort was so critical to our success that we needed the best talent in the organization to oversee it and drive it to completion. This sent a message to everyone in the company that we were serious.

The teams initially explored a series of cost-control frameworks, but the most powerful was a strategic approach known as zero-based cost management. This unique, holistic approach involves a fundamental reassessment of the entire business to answer these questions: Which activities and assets still fit with the company's future goals and strategy, and which should be improved or eliminated? How much funding is required to support each necessary activity or asset at peak performance? And finally, which budgets must we alter to reach cost management targets? Simply put, in zero-based cost management, the budgets for assets, operations, functions, and departments are rewound to nil as a starting point so a fresh argument can be made for every funding and portfolio decision.

The results of this focused cost management and reduction analysis were presented to the company's leadership. After approval, a commitment session was held with the managers of each of upstream Europe's functional groups that could challenge the findings. If those groups did question the budget levels, a discussion ensued so they could reach a consensus. Ultimately, we obtained a commitment from these functional managers to meet the proposed cost limits, which were subsequently embedded in the business plan.

A Three-Step Implementation

A zero-based cost management implementation can be broken down into three steps.

Step 1. Reexamine the company's goals and strategies. This sounds dramatic and disruptive, but in fact it isn't. We simply needed to have a series of pragmatic discussions among members of management, both upper level and midlevel, throughout the organization about where we thought the business was going in the next few years. The goal is to define a common reference point for everyone, a set of outcomes against which we can evaluate costs. Done well, this creates an environment for innovation and change by aligning people to a common goal.

We didn't conduct a wholesale reexamination of strategy. We simply asked, What are we trying to do as a company and which activities are needed to execute our plan? Stacked next to this was our new budget expectation or target of reducing costs by 30 percent.

Also at this stage, we explored competitive repositioning of the portfolio. We ranked each of our assets by how well they were able to compete for capital and resource allocation within Shell at their current level of performance. This wasn't an overly detailed exercise, but instead an effort to get an idea of where our best cost management opportunities would be found.

Step 2. Zero-base the activities. In this stage, we dove in deeply, stripping all business areas down to zero and then going through the exercise of building them back up. To do this, we asked, What is the minimum resource required to run each part of our business — that is, to cover the cost of those activities necessary to comply with legal, corporate, and regulatory rules as well as to achieve production targets? These are the "must-haves"; all other activities are essentially discretionary and optional, or in the zero-based framework, "nice to have." Given the risks and dangers of our business, HSE is always a "must-have." Much of what organizations do, however, involves an implicit choice about what to do above and beyond these "must-have" activities.

Less imperative to operations, "nice to have" activities could in principle be eliminated without affecting the company's license to operate. But the company's competitive position may well be affected. As a result, "nice to have" activities must be separated into those that are needed to continue to support growth and marketplace performance and those that could be changed or even shelved completely. The ones we chose to maintain were certainly discretionary but were nonetheless considered distinctive and critical to our ultimate goal of being the most competitive and innovative energy company.

In some ways, identifying the keepers is the easy part. Discerning which activities can be terminated demands a great deal of discipline and dispassion, and requires smart, diligent teams who can prepare the business argument for or against them. Often, certain activities are green-lighted and well funded year after year because that's the way it has been done historically at the company, even though these activities may have outlived their usefulness. For instance, a business unit may have at one point established teams to adopt and implement global standards, but these groups may have been rendered essentially irrelevant when the company set up centralized corporate standards centers that called on outside subject matter experts as needed. In our case at Shell, by canceling unused software licenses for the dozens of applications that we'd amassed over the years — such as geological imaging systems needed by only a small percentage of the people who had been given paid access to them — we were able to save millions of dollars without weakening operations in the least.

Moreover, sunk costs can sometimes persuade corporate executives to keep projects alive, with the idea that shutting down a project essentially wastes the resources already invested in it. As appealing as this notion of avoiding waste may be, it is foolhardy if better value can be unearthed elsewhere, in another project or asset. Tough and intelligent choices must be made about all activities for the full long-term impact of zero-based cost management to be felt.

Step 3. Adjust budget lines for surviving activities. After the "must-have" and "nice to have" activities were identified, we began the task of allocating the funding required to best manage our critical assets and projects. This means we actually lowered our budgets to match the expectations derived from the zero-based assessment. From this analysis, we could see whether after budgeting for all the activities core to our operations we could reach the 30 percent cost savings we envisioned. Had we failed to reach that goal, we would have had to pare back the discretionary activities and assets further.

Clarity and Commitment

In undertaking this exercise, we learned relatively quickly that there are many ways to challenge budgets for discretionary activities. For example, ask yourself, "Which activities can be simplified or aggregated?" Just because an activity is necessary doesn't mean that it is being performed efficiently. In addition, similar activities may be duplicated across functions. Such cases may be widely known but remain unaddressed because changing them would be complicated, time-consuming, or difficult politically within the organization. In the zero-based approach, these impediments should be circumvented, once and for all. For instance, we combined and reduced "nice to have" finance and services activities linked to oil well operations.

At Shell, one of the key opportunities for cost efficiency was in rebalancing the work that we manage in-house and the work we contract out at our assets. We've increasingly embraced an outsourcing model for maintenance activities, but over time this has proven to be insufficiently flexible in reacting to market developments and business requirements and has resulted in additional costs. For instance, an integrated services contractor that performs a variety of tasks over numerous assets handles the frontline maintenance in our facilities. However, during our zero-based budget analysis, we realized that by bringing some of this work in-house, we could save on the cost of maintenance and reduce expenditures targeted for logistics and supervision. Particularly on offshore rigs, a tremendous amount of money is spent on moving contractors on and off the platforms and on coordinating their schedules.

Consequently, at one offshore project, we found that by in-sourc-

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ing maintenance typically handled by an outside contractor's 30-person crew, we were able to improve costs materially. The Shell payroll and head count increased somewhat, but by fewer workers than the contractor employed because existing on-site teams could expand their responsibilities to handle some of the maintenance work. And thus by simplifying logistics and supervision, we found additional real savings. As importantly, the total number of workers spending time on drilling platforms dropped; hence, there was less worker exposure to potential health, safety, and environment risks.

At one offshore project, by in-sourcing maintenance, and thus by simplifying logistics and supervision, we found real savings.

Once we brought more of our maintenance in-house, ancillary gains could be explored. We examined, for example, the frequency and nature of the shutdowns we scheduled for upkeep and repair. Inefficient patterns, like cost creep, tend to grow in an organization over time. We found cases in which an asset was shut down just prior to, say, a public holiday — which created an extended shutdown that wastefully added nonproductive days to the operations schedule and forced us to pay premium rates for workers and equipment.

Besides the oil and gas production assets themselves, we found savings in each of the functions that provided support, such as finance, human resources, and IT. We already had shared financial services, the routine back office–like operations, located in Shell operations centers in several locations globally. But using the zero-based lens, we were able to optimize our use of finance experts — who, among many other things, do cost-benefit and appraisal analyses on assets and projects — by eliminating overlapping and redundant activities and spreading their work over multiple units.

And we zero-based our non-operated ventures, those in which other companies manage oil and gas assets in which we have a stake. We interviewed the people in the companies running these joint ventures and asked, "When you look at Shell as a partner, what do you think we add to the operation? Are we efficient? Can we do better to help hold costs down? In what ways?" We also ranked these non-operated assets by five criteria: HSE risk, material value to Shell, Shell's ability to influence operations, Shell's confidence in the operator, and how well technology was applied. We then classified the non-operated assets into two categories: those in which we could have a real and lasting impact on the expense curve in a way that would improve Shell's financial performance substantially and those in which we should basically be hands off. This allowed us to vary resource allocation, in both governance and activity budgets.

Implementing a Zero Base

Several critical attributes are necessary to make sure that a zero-based effort is embraced by the organization as an actual step-change tool. Among them: having visible management commitment; having clarity and transparency about specific expectations, deadlines, and savings; having dedicated resources to drive the program; and supplementing the effort with symbolic high-visibility interventions or events, including frequent management discussions that emphasize the importance of the opportunity to the company's competitiveness.

It may sound overly confident, but I was certain from Day One that our program would succeed, in part because I and the other managers were dedicated and committed to it and were not willing to accept failure or complacency. Not by being tough, but by being inclusive and committed, we created the environment for change and the motivation to deliver. It has taken 30 percent or more of my time to manage the process and to continually show that I am engaged, ready to communicate the appropriate management messages, and ready to direct the effort as needed. Because the program is being phased in over three years, the results are not yet in, but we are well on track to meet our goals.

The zero-based approach is not a one-time event, nor is it self-propelling. But with the right mix of management support and diligent analysis, this approach will yield sustainable results that are impossible to achieve with even the most diligent continuous improvement campaign. +

Reprint No. 11402

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is published by PwC Strategy& Inc.
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