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# Insight

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# Give partnership a chance LNG supply chain management

By Andy Aston, Regional Director, natural resources, Asia

**As LNG project costs soar around the world, Turner & Townsend's Regional Director of natural resources in Asia, Andy Aston, argues it could be time for a switch from adversarial supply chain management towards a more partnership-based model. This could help to enable better cost, time and quality outcomes for major programmes, and lead to repeat business for suppliers.**

Of the six onshore greenfield LNG liquefaction projects currently under construction in Australia, five have so far reported cost overruns, ranging from 16 to 46 percent. Such overruns create commercial challenges for operators, who have based their business case on achieving First Gas at a specific cost. One option for preventing these escalations is to consider alternative supply chain arrangements, using early-stage contracting models that can establish a win-win delivery environment, minimising claims and cost overruns.

"We have seen many instances of projects that are not prepared to have the hard conversation about working in a partnership, preferring to choose the easier, lowest cost, technically acceptable contracting approach. This is often followed by adversarial relations post-award. Partnership is a different philosophy for the LNG industry. We have seen the benefits it has brought to other industries and it is an option that we actively encourage our clients to consider."

At the moment, the oil and gas sector relies almost exclusively on competitive tendering, with very few cooperative partnerships. There are two factors behind this, explains Andy. Firstly, most oil and gas companies run on a localised project basis, so although there is a central contracting and procurement organisation, the influence of most corporate headquarters is not able to be effectively applied over distance. Project managers who make local decisions can be driven by their own personal opinions and objectives rather than corporate goals, and potential global supply benefits.

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Secondly, some oil and gas operators continue to opt for competitive tendering because it used to mean they could transfer risk onto the contractor with a lump sum award. But increasingly, that too has its challenges. Demand for EPC (Engineering, Procurement, Construction) and EPCM (Engineering, Procurement, Construction, Management) services is currently so high globally that many contractors can pick and choose which projects they work on and don't have to settle for lump sum awards. This is less true in the Middle East, notes Andy, but applies in North America as well as Australia. Consequently, risk must be shared between operator and contractor, so a substantial part of most contracts is now awarded on a reimbursable cost basis – but without necessarily managing this component in a collaborative way.

This is where Andy says partnering comes in: if you go open-book and give the contractor an agreed percentage of overhead and profit, you can then get on with delivering the job to schedule and budget, rather than spending time fighting claims, and spending effort and resources that could have been better spent on project delivery.

Based on projects that Turner & Townsend has been involved with in other industries, Andy sees major advantages that could be applied to oil and gas projects. One such highly successful project was Heathrow Airport Limited's (HAL, formerly BAA) £4.2bn Terminal 5 expansion, which was delivered to schedule and on budget. Recognising the challenge of integrating all stakeholder requirements and meeting

Public Inquiry commitments, while delivering to cost and time standards, HAL, Turner & Townsend and others redesigned its development and delivery processes, and undertook a global sourcing exercise, based on collaborative and partnership approaches.

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But is the technique applicable to the LNG operating marketplace? It could be, if taken seriously enough, argues Andy. Partnership is not a panacea, but as oil and gas companies see project costs rising, contracting strategy and risk become more important tools for management. So it needs to be considered as a larger component of the overall decision-making criteria, rather than as an afterthought. At the moment, LNG projects are largely technologically driven – and that's understandable given their complexity – but the commercial angle also needs to come to the top table, rather than playing a subsidiary role in decision-making.

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Contract conditions put down by the operator can be so adversarial that the contractor has little choice but to routinely limit communication and consider disruptive and costly legal claims. Even then, analysis of major EPC contractors' net margins suggests an average return of just three to five percent, so adversarial contracts don't appear to be working for contractors either.

As long as the operator can offer a stable margin above the norm, it could be in the contractor's interest to work in a collaborative way – especially as that may lead to more work in the long term. Where there is potential for broader global cooperation, with the key EPC and operators who have multiple projects, the rationale for partnership is even stronger.

Operators may be concerned that a guaranteed margin will leave little incentive for the contractor to keep costs down, but that can be addressed by agreeing and monitoring a budget, and building incentives for outperformance into the contract. Beyond that it's down to trust, says Andy, which links into our 'Inputs to partnership' framework (see table) – if you can't trust your contractor, or don't believe you have transparency, then partnership may not be the right way to do it. You have to check against that list of ten inputs – do they have the adequate resources and tools to do the job? Have they put the right management team in? When they say they can be creative in solutions what does that mean? If you give them an acceptable margin you must be sure they are not going to come back to you every six months for more.

Partnerships are not always the right option, but given the cost blowouts we are seeing, they are worth considering. If operators seeking partnership can't change the confrontational philosophy of a contractor then it's not the right way to go. In that case, try for a lump sum tender award, accept there's going to be an adversarial relationship and plan for that, but don't discount the benefit that an effective working relationship between parties can bring.

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## Inputs to partnership – critical success factors

| | Variable | Definition |
|---|---|---|
| 1 | Adequate resources | People, data, equipment made available |
| 2 | Management support | Senior management commitment? |
| 3 | Mutual trust | Sharing all levels of data |
| 4 | Long-term commitment | What investment has been made to make the partnership work? |
| 5 | Coordination | Are the companies working together? |
| 6 | Creativity | Innovation and positive change |
| 7 | Effective communication | How and to what extent? |
| 8 | Conflict resolution | Is there any, and how is it resolved? |
| 9 | Perceived satisfaction of partner | Is the partnership seen to be working on both sides? |
| 10 | Compatible goals | Do they meet each other's needs? |

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