Making energy industry joint ventures work

Toward improved governance and decision making
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About the author

Christopher Dann is a partner with Strategy& based in San Francisco. He specializes in strategic decision making and risk management in the energy, industrial, and infrastructure industries and works closely with senior executives on corporate and business unit strategies and risk management.
Energy projects tend to be big, complicated, expensive, and risky. As such, they are often pursued through joint ventures and other multi-owner entities, to spread the project’s risk and expense and to provide the resources and capabilities needed to cope with the complexity. But these structures are complicated themselves and are often bedeviled by strategic misalignment. The misalignment typically comes from divergent expectations among the varied owners about their respective roles. Partners also often have different agendas, which can quickly get in the way of a smooth-running project.

Shortcomings in governance and decision making add to the operating challenge. Often, when multi-owner structures are initially organized, insufficient attention is given to the many governance issues that will invariably arise. Similarly, decision-making processes are typically not designed to deal efficiently with complex, multi-stakeholder issues.

Dramatic improvements in the efficiency and effectiveness of joint ventures can be achieved in three ways. First, the partners need to clarify and communicate their strategic intent and objectives up front, at the time the arrangement is established. Second, they need to identify the roles that the project will require, and the capabilities available among all operating and non-operating partners to fill them, and then allocate assignments for each entity. Finally, they need to design a more powerful and relevant governance model and adopt a decision-making process that is iterative and tightly focused. These steps can also be taken in projects that didn’t start out with the proper safeguards in place and are now in need of them.
Key highlights

- Multi-owner structures are commonly used in big energy projects and in other capital-intensive industries.

- Though these structures spread the risk and the expense, they can also result in strategic misalignments among the partners that create operational difficulties.

- Projects can also get bogged down because governance and decision-making processes lack the special features to oversee and manage such complex entities.

- To avoid such problems, care should be taken when these organizations are being formed to understand each partner’s strategic position, assess the partners’ capabilities and roles, and install effective governance and decision-making mechanisms.

- Midcourse corrections can repair these problems in multi-owner structures that were launched without the proper analysis and safeguards.
The many virtues of joint ventures

Joint ventures and other multi-owner structures are extremely common in the energy industry and other capital-intensive businesses — and for good reason. Many energy projects are simply too big and/or too risky for one party to shoulder alone. Multi-owner structures are common in oil and gas exploration and production, refineries, and power generation.

A joint venture approach can effectively combine capital with the operating capabilities such projects typically require. Minority stakeholders gain portfolio diversification and can secure access to attractive energy resources at a favorable rate. In oil and gas exploration and production, for instance, minority stakes are often the only means for some players to gain such access.

In many cases, multi-owner structures are extremely effective in creating shareholder value over the life of the project, which may span decades. Companies with complementary assets and/or capabilities can often create more value through joint venturing than they could achieve on their own. Developing certain energy resources and assets requires specialist capabilities — the technological expertise needed to extract gas from shale, for instance — and joint ventures can facilitate collaboration and knowledge transfer in these cases and more generally. Furthermore, studies have shown significant value gains following the announcement of the formation of a joint venture, a reflection of market appreciation of multi-owner structures in the energy industry and a boon to the original stakeholders, which may sell their interests before the project ends or the underlying assets are sold.

Value gains aside, in some energy industry segments, regulatory barriers to either single ownership or mergers and acquisitions render joint ventures a necessity. For example, although the U.S. utility industry is extremely fragmented, with numerous subscale utilities, mergers and acquisitions are often stymied by regulators. In these cases, multi-owner structures can bring some much-needed scale benefits. Joint ventures also can create greater flexibility for the
partners in making investment decisions, since the availability of partial stakes in the project provides them with the opportunity to buy and sell interests in an option play.

Although multi-owner structures offer clear and compelling benefits, they are also highly complex entities, requiring a critical set of capabilities from some participants and a high degree of cooperation from all. Indeed, the challenges to managing multi-owner structures are significant and can easily prevent these investments from achieving their anticipated value. In our experience, these challenges emerge along two primary dimensions: strategic misalignment and ineffective and inefficient governance and decision making.
Strategic misalignment challenges

Owners and operators can find themselves significantly misaligned with respect to strategy, objectives, requirements, financial capacity, risk tolerance, and other key elements of a project. The misalignment can occur at the outset or develop over time. Strategic alignment often depends on the owners’ and operators’ expectations of their respective roles. Four distinct roles can be played (see Exhibit 1, page 9).

Passive investor/holder: Typically a minority owner, sometimes a financial investor such as a pension fund, and often with limited operational capabilities. Passive investors are primarily interested in governance and monitoring for value preservation. Their time horizon is generally the life of the asset. Small municipalities that own minority shares in large baseload power generation also typically play this role.

Active investor: A majority or minority owner that will take an active interest in the creation of value, often seeking to leverage capabilities in an episodic manner — for example, when an older coal-fired power plant is being retrofitted with a scrubber to improve its environmental performance — and frequently hoping to monetize this value creation in a relatively short time frame.

Contributor: A majority or minority owner that seeks to make an active, regular contribution to the operations and performance of the project. A contributor is an owner that brings significant capabilities to the value potential of the project and is often, but not always, the operator as well as an owner.

Portfolio manager: Often the operator, this player seeks to apply across a broader portfolio of assets the capabilities, the lessons, and sometimes the resources that are being developed or deployed on a single multi-owner asset. Operators of exploration and production assets in oil and gas frequently play this role, leveraging joint ventures in a particular region as part of a broader portfolio strategy.

A frequent source of problems with managing multi-owner assets is misaligned expectations with respect to the roles played by majority
owners, minority owners, and operators, whether owners or owners’ agents.

In many circumstances, the operator, often also the majority owner, expects the other owners to take the role of passive investor. But this position can be at odds with what the other owners expect or, in fact, are required to do on behalf of their shareholders, regulators, lenders, or other stakeholders. For example, the strategic objectives of minority owners often include building their own capabilities by capturing knowledge from their partners. Fulfilling these objectives requires a high degree of active involvement, yet their desire for greater transparency and influence may be met with resistance from operators that expect a high degree of autonomy and independence.

Sometimes the misalignment is caused by outside factors. An owner’s perspective may change, for instance, because of external economic or market shifts that affect its portfolio broadly but are unrelated to the joint project. Such shifts may also cause formerly passive minority owners to become suddenly eager to build capabilities or knowledge that would be useful for application elsewhere in their portfolio.

And sometimes the nature of the asset being managed can change. Thanks to the advancement of technologies such as hydraulic fracturing, oil and gas assets that may have been regarded as mature and declining can once again become significant sources of growth, resulting in the need for new capital investment.

The challenges of strategic misalignment can be compounded by distrust between operating and non-operating owners, another common affliction in multi-owner assets. Distrust can arise from an operator’s disregard for the other owners’ objectives, frequent surprises in asset operations or performance, and, occasionally, perceived or actual incompetence on the part of the operator. Distrust can complicate the partnership considerably, even leading to irreconcilable differences that cause the partnership to dissolve (see Exhibit 2, next page).

Because external dynamics, asset conditions, and owner circumstances can change, multi-owner projects require flexible governance and decision-making mechanisms. At the same time, though, these mechanisms have to be rigorous, thorough, and efficient. Shortcomings in governance and decision making are the other significant challenge with multi-owner assets.
**Exhibit 1**
**Roles and goals of owners and operators**

<table>
<thead>
<tr>
<th>Role</th>
<th>Objective</th>
<th>Perspective</th>
</tr>
</thead>
<tbody>
<tr>
<td>Passive investor/holder</td>
<td>Preserving value</td>
<td>Governance/quality assurance</td>
</tr>
<tr>
<td>Active investor</td>
<td>Extracting maximum value</td>
<td>Commercial/transactional; looking for opportunities to build or divest</td>
</tr>
<tr>
<td>Contributor</td>
<td>Adding/creating value</td>
<td>Engagement/operations</td>
</tr>
<tr>
<td>Portfolio manager</td>
<td>Creating/delivering on portfolio effects</td>
<td>Leveraging/building capabilities and assets</td>
</tr>
</tbody>
</table>

**Source:** Strategy&

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**Exhibit 2**
**The effect of strategic misalignment on trust**

<table>
<thead>
<tr>
<th>Strategic alignment</th>
<th>Trust in operator</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>Incompetent operator</td>
</tr>
<tr>
<td>Low</td>
<td>Broken partnership</td>
</tr>
</tbody>
</table>

**Source:** Strategy&
Governance and decision-making challenges

Decision making in multi-owner structures is often extremely difficult because it combines complexities existing in three dimensions:

**Stakeholder complexity:** Joint ventures and other multi-owner structures involve multiple organizations that can vary widely with respect to their risk appetites and tolerances, governance and control processes, and, as discussed above, strategies and objectives. These disconnects can vastly complicate the process of achieving alignment and commitment on decisions.

**Information complexity:** Investments in the energy industry are usually made under conditions of significant uncertainty. Commodity prices, capital costs, and regulatory and policy conditions, among other factors, can quickly change, sometimes radically. Information that is essential to anticipating and understanding these shifts and their implications for the investments is constantly evolving. Multiple owners will often have unequal access to the information, not to mention differing viewpoints, perspectives, and biases in the way they interpret it.

**Decision complexity:** As noted earlier, joint ventures are often formed because the investments involved are too big and/or too risky for one player to handle on its own. By definition, these ventures involve complex decisions with high risk and uncertainty, numerous variables, and often interrelated decision drivers. The analysis used to reach decisions is not straightforward, and there can be competing and inconsistent views among multiple owners.

The challenges presented by the complexity of decision making in this environment can be compounded by ineffective and inefficient governance mechanisms. In our experience, the problems with governance usually begin at the beginning, with the initial joint venture design or owners’ agreement. Multi-owner structures are much more complex to negotiate than acquisitions, but often the same team is involved and brings the same mind-set to the transaction, focusing on price and execution. Unfortunately, that mind-set doesn’t
take into account the large number of governance issues that need to be addressed when working out the details of a joint venture (see Exhibit 3).

Indeed, multi-owner structures are markedly different from acquisitions in the level of effort required to make them succeed, the time horizon, the level of commitment from the parties, and the degree of required management integration. A typical multi-owner governance structure requires a high degree of management integration between non-operating owners and operating management (see Exhibit 4, next page).

One critical element that sets multi-owner structures apart is the requirement for joint decision making. In this situation, the advocacy/approval process through which many organizations reach decisions is particularly ineffective and very inefficient. Typically, a team (in this context, usually the operator management) develops a recommendation, which it then advocates to decision makers. The decision makers probe and challenge the recommendation, ask questions, and test assumptions. The team repeatedly spends time and resources defending the recommendation, and the process often cycles through multiple iterations. In a multi-owner context, this cycling is often occurring not only between owners but also within each owner’s organization, which adds to the challenge.

Exhibit 3
Negotiating an acquisition vs. a joint venture

<table>
<thead>
<tr>
<th>Effort to close transaction</th>
<th>Acquisition</th>
<th>Joint venture</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deal issues</td>
<td>75%</td>
<td>100%</td>
</tr>
<tr>
<td>- Transaction price</td>
<td>0%</td>
<td></td>
</tr>
<tr>
<td>- Due diligence</td>
<td>25%</td>
<td></td>
</tr>
<tr>
<td>- Contract writing</td>
<td>25%</td>
<td></td>
</tr>
<tr>
<td>- Relative level of contributions</td>
<td>50%</td>
<td></td>
</tr>
<tr>
<td>- Treatment of future sources and uses</td>
<td>25%</td>
<td></td>
</tr>
<tr>
<td>- Ownership and control</td>
<td>25%</td>
<td></td>
</tr>
<tr>
<td>- Managerial structure and team</td>
<td>25%</td>
<td></td>
</tr>
<tr>
<td>- Succession planning</td>
<td>25%</td>
<td></td>
</tr>
<tr>
<td>- Veto rights</td>
<td>25%</td>
<td></td>
</tr>
<tr>
<td>- Performance management and controls</td>
<td>50%</td>
<td></td>
</tr>
<tr>
<td>- Contingency plans</td>
<td>50%</td>
<td></td>
</tr>
<tr>
<td>- Conflicts of interest</td>
<td>25%</td>
<td></td>
</tr>
<tr>
<td>- Cultural differences</td>
<td>75%</td>
<td></td>
</tr>
<tr>
<td>- Exit clauses</td>
<td>100%</td>
<td></td>
</tr>
</tbody>
</table>

Source: Strategy&
Exhibit 4
Typical multi-owner governance structure

- **Owner 1**
  - **Owner representative**
  - **Operations committee**
  - **Entity 1**

- **Owner 2**
  - **Health, safety, environment committee**
  - **Owners committee**
  - **Operator management**
  - **Entity 2**

- **Board of directors**
  - **Compensation, nomination, audit, etc.**
  - **Operator management**
  - **Entity 2**
  - **Project oversight**
  - **Entity 3**

Source: Strategy&
Ensuring success with joint venture projects

Joint ventures and other multi-owner structures can be highly effective vehicles for creating value in the energy industry. But they require management attention along three critical dimensions: understanding strategic intent, assessing capabilities and roles, and designing an effective governance and decision-making model.

Understanding strategic intent

Taking the time to understand the strategic intent and objectives of the partners is a critical step in the formation of a joint venture. But it is also an exercise that needs to be repeated periodically because partners’ strategic objectives are likely to change over time.

One means of disentangling the strategic perspectives of multiple partners is to begin by asking this question: What strategy would produce maximum value for this asset if there were only one owner? By beginning with this shared understanding of fundamental value creation, the partners can more clearly discern their own and one another’s perceptions of value and, therefore, strategic objectives, and they can engage in a transparent discussion of where and when these objectives are aligned or misaligned.

Assessing capabilities and roles

As seen in Exhibit 1, page 9, joint venture operating and non-operating partners often have very different expectations, based on their strategic intent, about their role and the roles of their counterparties. Some partners seek to apply capabilities, some seek to build capabilities, and some are content with a passive role. The operating partner usually has placed a premium on the asset because of its role as operator. In other words, the operating partner would not place the same value on the opportunity if it did not have operational control. Moreover, the operating partner often believes it has greater capabilities than its
counterparties to maximize value, which is one reason that operating partners often prefer passive investors.

To avoid misaligned expectations and make the most of the joint venture structure, owners need to jointly assess the capabilities required to maximize the value of the asset, and then allocate roles based on each operating and non-operating owner’s particular strengths and capabilities.

**Designing an effective governance and decision-making model**

With clarity about each owner’s strategic intents and capabilities, a governance and decision-making model should be designed that allows each owner to fulfill its strategy, leverages capabilities, and maximizes the efficiency and effectiveness of joint decision making. The governance model defines the roles, responsibilities, and decision rights of the owners committee(s), the operating committee(s), the operating management, and other owner representatives. The model defines the processes that are used for information sharing, performance review, capital allocation, and decision making.

With respect to decision making specifically, an iterative, structured decision-making process helps avoid excessive or unproductive cycles of review and approval, and ensures that the operating team and the decision makers are brought into alignment (*see Exhibit 5, next page*).

**Conclusion**

When well designed, the governance and decision-making model will enable management integration, ensure strategic alignment, and enhance trust. This model, combined with a shared sense of strategic intent and capabilities, will allow multiple owners to deliver on the promise of joint opportunity and create greater value together than each could create individually.
**Exhibit 5**
The iterative joint decision-making process

**Owners committee** (reps from all owner companies):
- Define agenda
- Review alternatives
- Review evaluation
- Decide

**Task force/subcommittee** (owner project leaders, subject matter experts):
- Develop alternatives
- Review alternatives
- Make recommendations

**Project core team** (technology, regulatory, fuel, market, and financial analysis):
- Propose alternatives
- Evaluate alternatives
- Develop recommendations
- Implement

Source: Strategy&
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