# Recreating the Argentine National Oil Company: A Paradigm for Privatization

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As has been widely documented, Argentina is in the process of dramatic change from a centrally controlled economy with protected markets to a competitive economy with open markets. The pace of change and its evident success testifies to the leadership of President Carlos Menem, who took power in July 1989. A central pillar of the change process is the privatization of state companies, of which YPF – the Argentine national oil company – has been the most dramatic example. In just two years, YPF transformed itself from a lumbering behemoth of 39,000 people with widely diversified activities, protected from competition, into a lean, efficient, highly competitive oil company whose initial stock offering was widely hailed as marking one of the most successful privatization efforts of our time. YPF's story offers useful lessons not only for companies undertaking privatization, but for all organizations striving to change.

## Background

In 1990, a deregulation decree abruptly ended YPF's monopoly of the country's crude oil supply. In June of 1990, about one-third of YPF's existing oil and gas fields were put on the auction block and it was announced that partnerships would be formed to develop several other YPF oil fields. Two months later, Jose (Pepe) Estenssoro was appointed president of YPF. In January 1991, YPF was transformed into a „Sociedad Anónima" – the legal framework of a public company – increasing its independence from the government and facilitating its management as a private enterprise. In February 1991, Domingo Cavallo was appointed Minister of the Economy and the pace of privatization picked up.

For YPF, the challenge was enormous. During previous administrations, the organization had ballooned to over 39,000 employees, plus a large number of contractors. It had accumulated a wide variety of assets, including schools, hospitals, and cinemas, in addition to its more conventional oil assets. YPF and the government faced several options: trying to shape up the entire company, dismantling it and selling off the assets, selling the company as a going concern, or shrinking it to a sustainable core and selling off fringe activities. They chose the last option on two grounds. First, eliminating inefficiencies should enable them to realize the company's full value as a going concern, which should exceed the value of its assets sold separately. Second, a substantial Argentina-based integrated oil company would provide both financial and nonfinancial benefits to the nation. The challenge was to transform YPF into a company that would attract outside capital.

YPF's situation was, of course, unique. But many organizations in both the private and the public sectors are facing similarly compelling challenges – challenges that require radical change to their organizational structure, resources, and key business processes. In short, they must move quickly to become what we at Arthur D. Little call a High Performance Business. High Performance Businesses create value for all their stakeholders. They provide good returns to their owners, cost-effective high-quality products and services to their customers, and good career opportunities and challenging assignments to their employees.

The same High Performance Business principles apply to private companies wishing to create value for their stakeholders and to state companies wishing to realize their intrinsic value through privatization. Using our High Performance Business model, Arthur D. Little has developed a comprehensive two-stage approach, first to transform, then to restructure organizations in need of radical change. We will use our experience of working with YPF to illustrate this process.

## Transformation

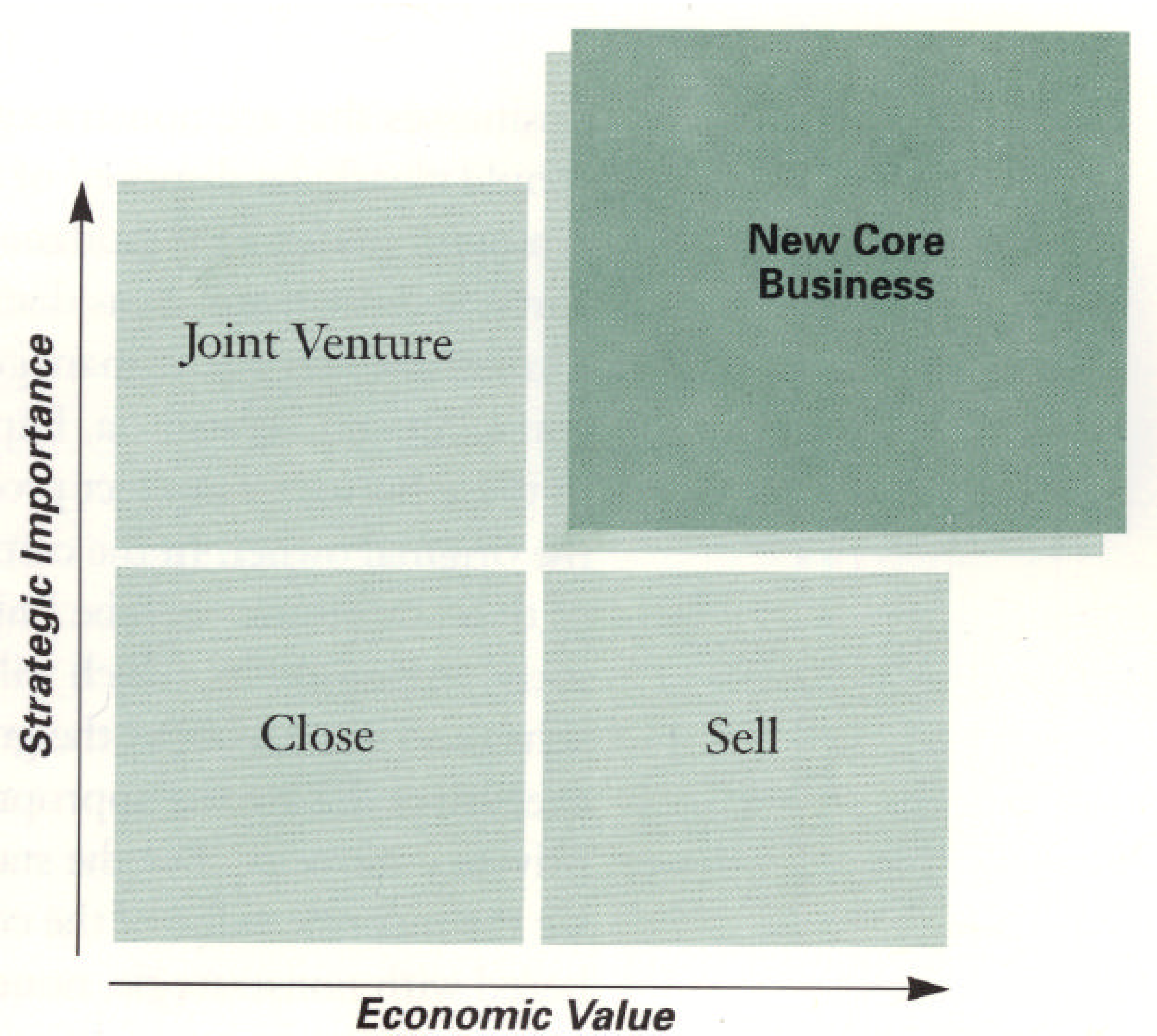
The first stage is the transformation of the company to focus on its core businesses that together have strategic integrity and good potential for a superior return on capital employed (Exhibit 1).

By „strategic integrity," we mean capacity to be energized collectively by vision and mission statements that provide a meaningful sense of direction and purpose. We have seen vacuous vision statements that in essence say „we'll be the best at whatever we feel like doing." Such flabby locutions give managers rein to distract themselves with all manner of peripheral activities. Vision and particularly mission statements should provide concrete direction about the scope, scale, and business focus of the enterprise. Anything that falls outside this vision should be considered nonstrategic. YPF decided to focus on specific oil basins and on the oil refining and marketing business.'

In this process, several painful decisions must be made. Businesses that are quite profitable but do not fit strategically must be sold. Sometimes these are businesses in which various senior managers have a substantial investment of „sweat equity." However, if there is no strategic fit, the business may be worth considerably more to someone else. Even if it is not, the hidden costs of strategic distractions can be large, as managers lavish on non-core businesses attention that could be better deployed on continuously improving core businesses. YPF sold off some very attractive natural gas pipelines that it recognized as being outside its chosen scope of business.

**Exhibit 1**

**Restructuring to Focus on Core Businesses**




Businesses that are strategic but make unsatisfactory returns pose a dilemma. They may be candidates for the turnaround measures described below. Alternatively, their poor performance may derive from a deficiency in skills, technology, capital, or market outlets that could be remedied by partnering or joint venturing. State companies will have to address these businesses with particular care, since their history of monopoly or quasimonopoly will make it difficult for them to contemplate relinquishing control. YPF decided to joint venture those producing areas outside the three core basins.

Businesses that are nonstrategic and noneconomic should clearly be disposed of or closed down. The government, under YPF guidance, sold Gas del Estado in parts, and the natural gas distribution businesses thus formed are now being managed by a variety of private companies and consortia. Experience tells us that some of these businesses in fact prosper when liberated from the original owner. In the case of state companies, some of these businesses will be linked to sensitive issues of social responsibility, which will undoubtedly cause headaches and heartaches as the government and company executives debate the appropriate roles of the state and private enterprise. But the state will not be able to realize the intrinsic value of the company if it is encumbered with nonstrategic, noneconomic baggage.

### Restructuring

Given a set of businesses that appear to have some strategic integrity, how should they be restructured into a High Performance Business? The answer will of course vary with the organization's nature and circumstances. At YPF, we worked with management to develop a four-phase methodology:

• In Phase I, we recast the corporation as a new high-level organization with clearly defined profit-centers grouped under two strategic business units.

• In Phase II, we constructed detailed business unit organizations, designed the vital business processes that would make the overall organization function, and established a measurement system focusing on return on capital employed that would lead executives to create shareholder value.

• In Phase III, we addressed key support processes to ensure that processes, policies, and procedures would be both efficient and effective across the company.

• In Phase *IV*, we went back to the new managers to find out what was working and what was not and helped them fix remaining problems. This step essentially gave full psychological „ownership" of the organization to the managers.

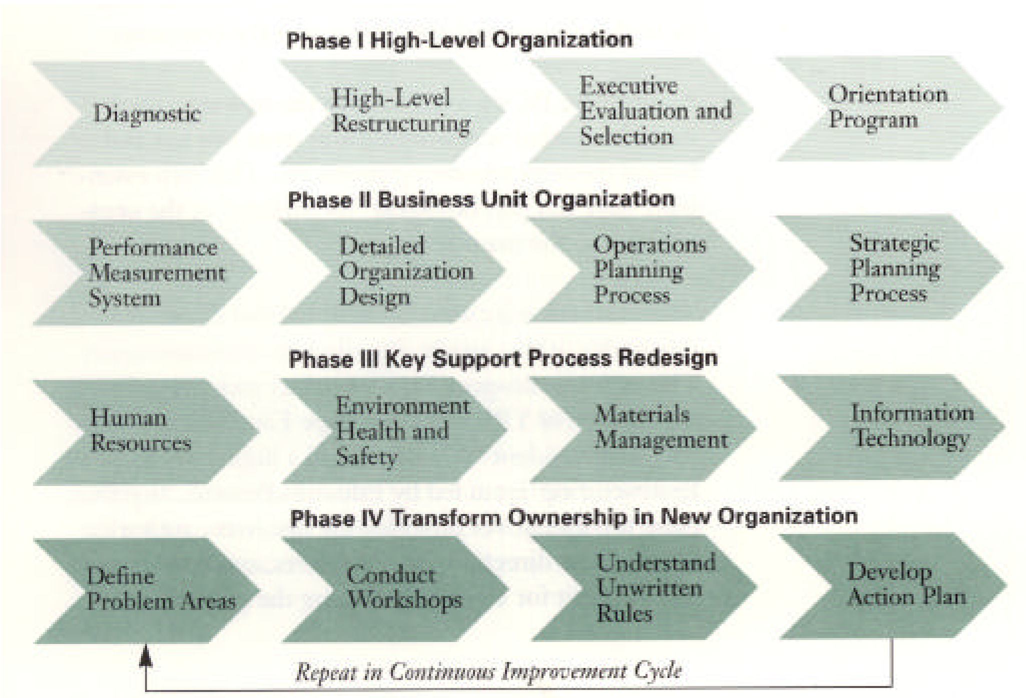
This methodology is outlined in Exhibit 2, and the remainder of this article describes its implementation. Throughout this process, we worked under the close supervision of YPF president Pepe Estenssoro, executive vice president Nels Leon, and a high-level internal Restructuring Team led by Eduardo Petazze. Together, these top executives provided the necessary authority, priority, and direction for our efforts, and they deserve all the credit for effectively driving the process.

**Phase I: High-Level Organization.** At the time we were retained, YPF was highly centralized, with some 25 vice presidents and senior managers reporting to the president and executive vice president. There was little information available on the profitability of the corporation and none on the profitability of individual business segments. The overall perception of managers was that their job was to administer costs and try to avoid crises. Clearly, responsibility and accountability had to be driven down through the organization. One issue was whether accountability should be on a functional or geographic basis.

We reviewed models in the oil industry and other industries, such as commodity chemicals, where several companies had restructured through leveraged buyouts in the late 1980s. The successful companies share a number of features. They emphasize focused management control, with a flat/lateral structure: „one riot, one Ranger." They also stress direct accountability, place more activities under the direct control of line managers, de-emphasize allocation accounting for management purposes, and expect people to „do it right the first time."

### Exhibit 2

### A Four-Phase Transformation Process



In addition, the successful companies share a drive toward simplicity. They have, in general, narrower product lines, fewer – but bigger – customers, rationalized regional coverage, more easily managed sales arrangements (e.g., long-term, f.o.b., etc.), simplified trade channels, and carefully controlled corporate costs.

Based on these insights and on a detailed appraisal of YPF's actual position in the Argentine oil industry, we decided on two strategic business units: Upstream (exploration and production) and Downstream (refining and marketing). The Upstream organization contained regional production profit centers and a single exploration function dedicated to building long-term value; the Downstream organization contained functional profit centers. We identified functional and regional organizational units that were spontaneously improving and tried to keep these together. Units that were badly broken were elevated to report to higher levels so that they could be given the high-level care and attention they needed. And we defined lean corporate service organizations, such as Human Resources, Environment, Health and Safety, Materials Management and Purchasing, and Information Technology, whose role was primarily to set policy and monitor adherence.

Having agreed on the structure, we assembled a team of early retirees from the oil industry, instructed them on the philosophy of the new organization, and developed an interview guide and evaluation methodology to allow them to evaluate internal and external candidates for key executive positions. We then supervised the activities of a major recruiting firm to fill the gaps.

**Phase II: Business Unit Organization.** In this phase, the vital first step was to provide the new strategic business units and the profit centers (business units) reporting to them with some management information. The accounting system could not provide it directly. A new accounting system was being developed but would take two years to complete. So we built a PC-based interim performance measurement system so that managers could trace their progress. This system assembled cost data from the general ledger and estimated gross margins from volumes and prices. It used market-based transfer prices between business units and an activity-based allocation system for overhead costs. We managed reasonable closure with the official accounting numbers, and this interim system formed the basis for the permanent system linked to the new accounting system.[1]

Then we had to figure out how the organization would actually work. We developed detailed roles and functions for all management positions and described the business processes by which they would accomplish their objectives. Particularly important was defining the high-level functions of the Board committees, since YPF had no history of governance by a Board of Directors. We installed an operations planning process and guided key executives through the first few iterations. We installed a top-down/bottom-up strategic planning process and worked with the business units in developing the first-ever strategic plan for the corporation. We also designed a new capital budgeting process.

### Phase III: Redesign of Key Support Functions.

There were still some gaps in the organization. The philosophy all along had been to push responsibility and accountability down in the ranks. Central service departments had the role of defining policy and – when economically justifiable – providing services to the SBUs. However, we had to define how this philosophy would be implemented. We wanted the SBUs to develop and implement their own strategies, but we also wanted to be sure that standards were upheld and available economies of scale were exploited. Arthur D. Little experts in these functional areas worked with the YPF team to determine appropriate levels of specialist staffing, reporting relationships, and the processes by which standards were set and reviewed.

### Phase IV: Ownership in New Organization.

Throughout the implementation process, YPF continued to operate in the highly dynamic Argentine environment. There were a number of bumps and sharp turns in the road. Although Gas del Estado was successfully dismembered and sold, the YPF plan to sell the petrochemical subsidiary was reversed, and this had to be reabsorbed. Meanwhile, competitors tried aggressively to take advantage of YPF's perceived weakness, customers demanded improved service, and some members of Congress continuously provided background material for newspapers to express as dissent. Staff levels were reduced from 39,000 on January 1, 1991, to approximately 8,700 on March 31, 1993, and contract labor, originally at about 15,000 persons, was reduced along the same proportions. Managers left and new managers arrived. Senior managers were often obliged to run their operations with key positions unfilled. In the heat of events, some people lost sight of the original organizational concept, while a number of key newcomers had not even been exposed to it. By early 1993, it was time to reinforce the message.

The first step was to restate the principle of decentralization and accountability. Next, we identified the issues through interviews with key managers. These were prioritized by the senior management group, and YPF teams were created to propose solutions. For the most intractable issues, we took a careful look at the „Unwritten Rules of the Game“[2] of the entities involved to gain insight on how to implement the team recommendations. Implementation of most of the team proposals effectively transferred „ownership“ of the organization to the incumbent managers.

### Results

In July 1993, approximately 44 percent of YPF was sold through a public offering on a variety of international stock markets in one of the most successful privatization efforts of our time. The sale generated over $3 billion for the state of Argentina and allowed the government to address the delicate issue of how to fund state pensions, which had become a political issue of great importance. Since then, the government has sold another 13 percent of the package and another billion dollars has changed hands. Furthermore, operating results so far have been encouraging. In addition to its massive reduction in headcount, the company has recorded a dramatic improvement in operating income, from a loss of 787 million pesos in 1990 to profits of 263 million pesos in 1991, 509 million pesos in 1992, and 714 million pesos in 1993. From its initial offer price of $19, the stock has risen into the low to mid $20s per share despite very low international oil prices, and analysts are forecasting continued rapid growth in earnings per share.

From start to finish, the restructuring process took two years. The high-level design and executive selection process lasted six months; detailed organization design required 12 months; and „ownership“ was transferred in a farther six months. Given the magnitude of the task, this was very rapid change. What made this pace possible?

### Success Factors

We have identified 10 success factors.

**Constant Pressure from the Top.** In this case, the President of Argentina and the Minister of the Economy were committed to privatization, and the CEO knew that he had to show investors a restructured, efficient organization in order to present a successful offering. Ultimately, the timing was set by political considerations. No slippage was tolerable. The CEO emphatically reinforced this message to the staff and to the consultants throughout the restructuring program.

**A Top-Down Fix.** A broken company cannot fix itself. If there are too many people, they will obstruct and delay change. Once the broad structure has been determined, approximate lean staffing levels need to be set and action taken for the supernumeraries. Although major cuts in staff are always traumatic, YPF chose a generous combination of severance and temporary contracts that softened the impact.

**Quick Installation of New Management.** Although it is possible for managers to double up responsibilities early in the change process, it is highly undesirable. The problem is the inevitable dilution of accountability. Bad habits are quickly formed, and a senior manager will find it difficult to pull back from detailed operations once he has started involving himself in them. Furthermore, there is a tendency to create „temporary“ staff support activities that will not go away even after all the management posts are filled.

**A Clear Philosophy.** Although we developed and implemented a phased approach, the fact was that almost every task was urgent. Furthermore, everything interlocked, so that delays in one area forced temporary solutions in another. In undertaking such massive change, the approach must be comprehensive, because facets of the old organization will frustrate implementation of the new organization. Therefore, a number of activities must take place in parallel, based on a strong understanding of and belief in the philosophy of the organization. For YPF, the High Performance Business concepts provided the necessary foundation for maintaining common principles in the different areas.

**The Right Time for Empowerment.** Once the headcount seems about right and the new managers are in place, the new organization can be empowered. It will now clamor for improved processes and simplified procedures and will be energized to develop them. For the CEO, this is a moment of truth. It isn’t always easy for him or her to stop directing the details of the organization and start relying on managers to continue the process.

**Attention to Central Services.** Many broken companies suffer from highly centralized organizations in which large central service organizations isolate the top management from operations. These central service departments enjoy great power and are reluctant to give it up. Furthermore, their performance is difficult to measure. Companies end up paying an enormous amount for „control“ that is more illusory than real. The answer is to emphasize the measurement of results and process effectiveness rather than the direct inspection and supervision of employees’ activities.

**Mastery of a Complex Battlefield.** A broken company attracts demons, and they must all be fought at once. This multiplicity of challenges requires an exceptional CEO. YPF had to simultaneously sell off assets under the transformation program, restructure the organization, prepare for its public offering and deal with an often hostile Congress. In 1987 and 1988, Texaco had to handle the Pennzoil settlement and unwelcome attention from Carl Icahn while transforming and restructuring itself. The trick is to establish separate activity centers to fight each demon, with the CEO as field marshal directing the generals to the main points of the attack and seizing the offensive where possible.

**Following the Right Order for Restructuring.**

In parallel with selling or joint venturing assets that are nonstrategic or uneconomic, the restructuring effort should follow a distinct sequence:

1. Recast the high-level organization

2. Complete the detailed organization and core business processes

3. Design information systems and other key support processes

4. Empower the new organization

Within each step, numerous activities need to be undertaken in parallel. For example, at YPF, refinery operations and maintenance processes needed to be developed simultaneously with corporate processes for purchasing and materials management. However, it is important to respect the fundamental logic of this overall sequence of events. Addressing these steps in the wrong order is enormously wasteful, as resources are spent automating bad processes, reengineering processes that should be rethought, reorganizing businesses that should be shed, and empowering managers who are then released. Furthermore, it is very important to complete all the steps in order to realize the full value of the effort. An exception to this order might be the development of a relational database early on, but application architectures should follow later to support the new organization.

**Anticipating Reaction.** Inevitably, the old ways of doing business will continue to exert a strong influence on the organization, even after a dramatic program of change. This reaction needs to be anticipated and specific measures taken to counteract it. In the case of YPF, we introduced a temporary position for a high-level „jedi knight" to preserve the philosophy, eliminate bureaucracy, and help with ongoing process improvement.

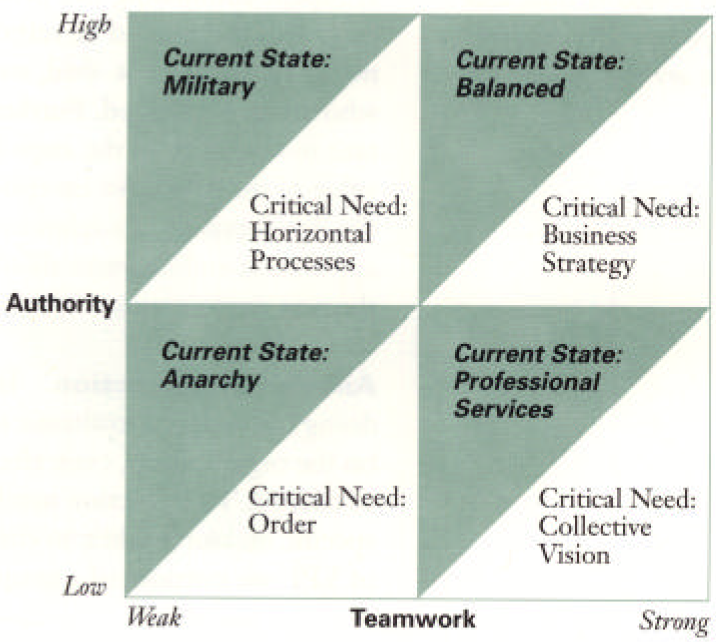
**Knowing the „Unwritten Rules."** YPF's various organizational entities had different unwritten rules. Our analysis employed two pairs of attributes that seemed particularly helpful in mapping each entity's condition: an inclination toward authority versus teamwork, and a tendency to focus inward or outward versus a disposition to be analytical or action-oriented (Exhibits 3 and 4).

One group in the company found themselves in the top right-hand corner of the first matrix – which would have been excellent if they had had a clue as to where they should be going. The problem was that they were in the bottom right-hand corner of the second matrix and had become very reliable at producing totally unsatisfactory performance. What they needed was benchmarking so they could understand what level of performance was possible. They are now aggressively pursuing world-class performance.

**Exhibit 3**

**Parameters Shaping Unwritten Rules:**

**Authority vs. Teamwork**

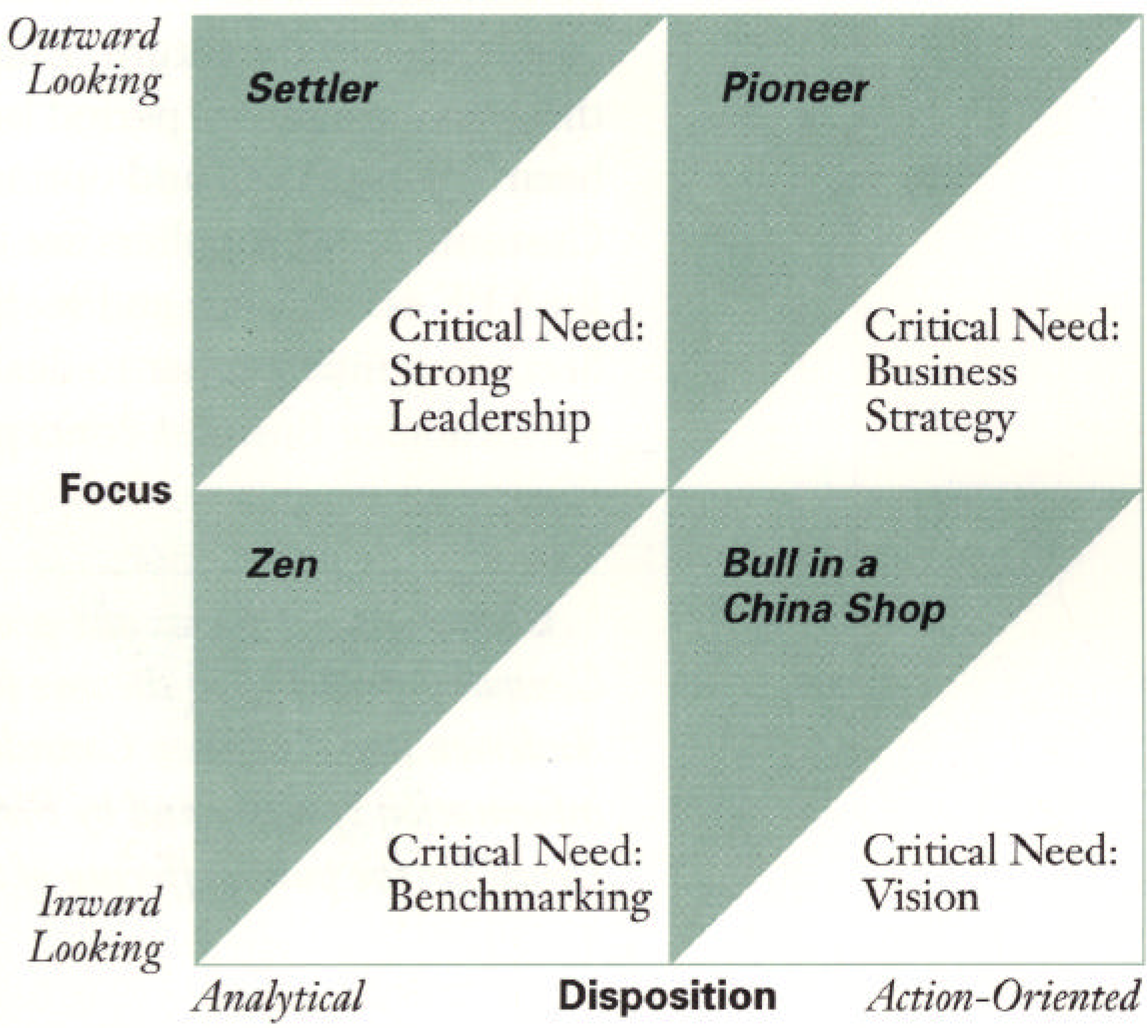


*The most egregious unwritten rule we encountered concerned the unwillingness of managers throughout the organization to make decisions. One manifestation of this problem was a widely recognized saying, „I pay you to work, not to think!“ This attitude stems largely from YPF's history as a national oil company, for which all decisions had been political. To change this mindset, YPF is continually forcing decisions at lower levels in the organization, always requiring economic and financial justification for each decision. Through this relentless repetition, the company is gradually eroding the perception that every decision has unknown* political ramifications that could have personal repercussions for the decisionmaker. Furthermore, YPF has linked compensation to performance, creating incentives for managers to take ownership of decisions that affect results.

**Exhibit 4**

**Parameters Shaping Unwritten Rules:**

**Focus vs. Disposition**




But new structures, processes, and performance measures are not enough on their own. It is also necessary to find the catalyst that will allow the organization's chemistry to react constructively; and this may be different for different parts of the company. We have found the Unwritten Rules of the Game methodology invaluable to this aspect of our work at YPF and elsewhere.

## Conclusion

Bearing in mind that only three years ago YPF was a drain on the government, the transformation appears almost miraculous. The Argentine government is wealthier by more than $3 billion, is receiving a steady stream of tax payments, and remains a significant owner in a corporation whose value continues to increase. Other shareholders are happy with the stock's performance so far and are encouraged by analysts' projections of the future. Employees have suffered through a traumatic period but are proud of what has been accomplished and optimistic about the future. Customers and suppliers are developing a new respect for YPF as a reliable and realistic company that is becoming much easier to deal with. The High Performance Business concept really works!

[1] *Assistance to YPF was also provided by McKinsey and Company for defining the core businesses, by Arthur Andersen and Andersen Consulting for accounting and information systems, and by First Boston and Merrill Lynch for the public offering of shares.*

[2] *For more information on the „Unwritten Rules of the Game" concept, see the 4th quarter 1993 issue of* Prism, *or see Peter Scott-Morgan's new book,* The Unwritten Rules of the Game.

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