

Hard Times, New Solutions

How the oil and gas industry
can develop sustainable
solutions to volatile pricing
dynamics



Oil & Gas industry executives know that they have to take a long-term outlook on their business and follow a consistent plan to effectively manage through the sector’s perpetual cyclical. This philosophy, however, is not always put into practice and is much easier to claim when times are good. As in the mid-1980s, and through the last 18 months, times of pronounced volatility often produce severe responses as companies scramble to keep up with fluctuations in the business. With notable exceptions among the super majors and some of the better managed National Oil Companies (NOCs), a large number of Oil & Gas companies – and therefore the many drilling and oil field services companies that serve them – surf the waves of commodity price volatility. During the good times, they acquire companies and assets, expand their capital budgets, geographic presence, and product and service capabilities. However, when there are dramatic price drops, as from July to December 2008, they divest business units and assets, and reduce budgets, presence, and capabilities.

Oil & Gas companies are responding to the recent volatility and to the larger global economic crisis in a very predictable manner: cutting costs quickly in order to stay afloat. Many, however, are not planning for or developing sustainable cost reduction programs, nor are they aligning their cost reduction efforts with their long-term strategies. In times of crisis, the immediate need to survive a dramatic price drop can trump consideration of how to thrive in a more favorable environment – the pain of hemorrhaging cash is just too intense to even think about planning for the return to profitability.

Planning for the future is exactly what is called for – both to survive in the short-term, and to be well positioned for the eventual uptick in commodity prices. This means implementing sustainable cost reduction efforts now. Companies must also focus on creating scalable yet flexible cost structures that can help them manage future shocks as well as capture growth opportunities.

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The Danger of a Short-term Approach

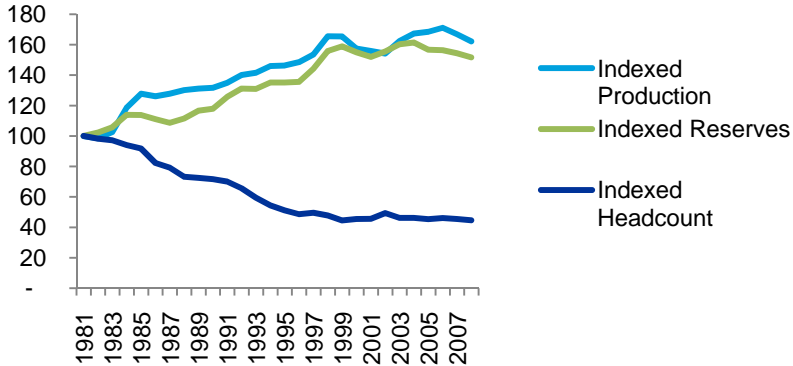
In the face of the most tumultuous economic environment in recent memory, some Oil & Gas companies are once again using layoffs as a primary means of cutting costs. And it’s easy to understand why: personnel reductions are typically perceived as “low-hanging fruit” when it comes to achieving rapid cost reductions, and have often been heralded as a winning formula among market analysts.

Oil & Gas companies were quick to reduce headcount during the downturns of the mid-1980s and 1990s, and the industry has been slow to rebuild its stock of human resources during recovering markets¹. Indeed, the industry has managed

¹ *Energy Headcount Slumps Despite Record Oil Prices and Bright Fundamental Outlook*, John S. Herold, Inc., April 15, 2005.

to increase production and reserves over the past two decades while keeping employment relatively flat in the recent past, which followed a downward trend of almost two decades (see figure 1).

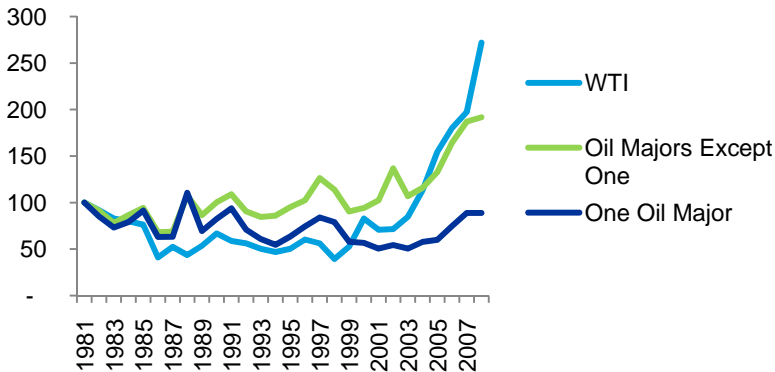
Figure 1: Indexed Headcount vs. Production and Reserves



Source: Deloitte analysis based on company financial statements and J.S. Herold database.

Statistics suggest that productivity has gone up significantly, but raises the question: “How much farther can it go?” Unless there are numerous and obvious productivity gains to be had, there is always the danger that Oil & Gas companies may be cutting muscle and bone instead of fat. This situation, when coupled with simultaneous capital expenditure (CapEx) reductions, could imperil a company’s ability to find, develop and replace much needed reserves when global demand rebounds. Evidence suggests that oil and gas companies, with a few exceptions, manage their CAPEX in sync with prices rather than following a long term strategy (see figure 2).

Figure 2: WTI vs. CapEx



Source: Deloitte analysis based on company financial statements and J.S. Herold database.

The risks of cutting too deep are significant – so much so that the International Energy Agency (IEA) addressed the issue in a report delivered at a recent meeting of the G8 energy ministers². In the report, the IEA framed the possibility that the 21 percent reduction in capital investment in upstream Oil & Gas posed a “real danger that sustained lower investment in supply in the coming months and years could lead to a shortage of capacity and another spike in energy prices in several years time, when the economy is on the road to recovery.” It noted that from October 2008 through April 2009, projects totaling over US \$170 billion (two million barrels/day of oil capacity and 2.3 BCF/day of gas capacity) were delayed by 18 months or more. Not surprisingly, the larger cuts were made in exploration.

Many believe that the dangers of aggressive cost cutting could quickly become apparent when there is a prolonged spike in oil prices and a resultant race to increase capacity. From a short-term perspective, organizations that have not reduced costs thoughtfully will lack the resources needed to increase supply and take advantage of the improving market, thus stunting growth and damaging shareholder value. From a broader perspective — as noted in the IEA report — the industry’s trend of decreasing investment could have “far-reaching and ... potentially grave effects on energy security, climate change and energy poverty.”

Framing Cost Reduction

To be able to survive and thrive during even brief dramatic price swings, Oil & Gas companies must design sound cost reduction programs that are aligned with long-term strategic objectives. Typically, these programs incorporate detailed scenario analysis, a healthy project portfolio mix, and decisions regarding “what to cut when” over a multi-year timeframe.

Deloitte Consulting LLP recently hosted a webcast on Enterprise Cost Management for Oil & Gas Companies, which was attended by over 700 participants. As part of the webcast, participants were queried on their current and future business situations as well as how they are balancing immediate cost cuts with future strategic considerations. The results suggest that companies, by and large, are doing what they have always done in a downturn, which is to focus on tactical cost reductions. This is a natural tendency since short-term reductions are often easier to implement and more readily understood by the investment community.

More strategic cost reduction efforts, however, typically involve doing “more with less,” whether through improved technology, productivity, or efficiency. Examples include streamlining business processes by cutting cycle time, reducing waste, improving response rates, and centralizing common activities. These measures are more challenging because they take planning and time to implement. They also involve changes in the mindset, culture and behavior of a company, and require commitment and leadership from the top. However, when done well, these efforts have typically produced lasting results that permanently alter the company’s overall cost structure by reducing fixed costs and lowering overall

² *The Impact of the Financial and Economic Crisis on Global Energy Investment*, International Energy Agency, May 2009

costs throughout the organization. This enhances a company's responsiveness and agility, and improves its ability to survive and prosper over the long run in a highly cyclical, capital-intensive business.

Planning Strategically for the Upturn

To increase their chances of weathering today's storm and to position themselves to take advantage of the upturn, companies should consider taking the following actions:

Ensure that cost reduction is executed as a program that is consistent with long-term strategy.

When Oil & Gas companies cut costs, they typically do so across regions, business units, and product and service lines. The problem is that these areas are rarely assessed using the same criteria. As a result, some are hit harder than others, which is often disproportionate to their ability to contribute to growth and profitability. This situation can hurt the company in the long-run if the cuts are made due to expediency and are not part of a coherent program that is consistent with a long-term strategy.

In essence, the long-term strategy should drive a company's cost reduction efforts and align to create the lowest possible cost structure, yet one that is scalable. To achieve this end, each area — regions, business units, and product and service lines — should be examined through three different lenses:

- **Risk & Liquidity:** For example, working capital improvement, tax and treasury optimization, and prudent risk management are all areas that, when used thoughtfully, can help companies generate and manage cash, while reducing reliance on capital markets during periods of decreased liquidity and higher costs of borrowing.
- **Operations:** Reducing operational and SG&A expenses can bring about significant and sustainable margin improvement. This can often be accomplished by focusing on productivity and efficiency, selective outsourcing, and reducing shared services costs. Strategies that shift fixed costs to variable ones can create a more flexible cost structure, which enables more strategic options.
- **Growth & Sustainability:** This area usually emphasizes CapEx optimization, including segmenting and balancing discretionary versus non-discretionary capital expenditures, deferring some spend, and negotiating improved contract terms. Companies should also look to increase profitability by optimizing pricing, contracting strategies, and margins via effective processes, analytics and technology. Additionally, business process rationalization cannot only help companies streamline costs but also lays the foundation for facilitating potential mergers or divestitures.

These types of activities are essential, but forward-looking companies will also want to go further: Those that have the financial wherewithal should be taking the opportunity now to make countercyclical moves. This includes increasing CapEx when competitors are cutting back; now is a great time to negotiate favorable contract terms and to obtain the “best deals.” Other aggressive measures include standardization, reducing overdesign and using advanced techniques like should-cost modeling and indexation to reduce costs and mitigate risks. Companies should also be prepared to become deeply involved with their suppliers, vendors, and contractors to help them manage costs.

Regardless of which cost reduction activities a company chooses to employ, all should be coordinated via a structured program, with milestones, metrics, measurement, and accountability that is aligned with the company’s strategy. A global energy company seeking to reduce its footprint in North American gas and enhance its presence in Asia and Middle East, is considering how this strategy affects its overhead cost structure, including supply chain, warehousing, operations and distribution centers, information technology, human resources, and regional and local finance organizations. Operating with multiple product and service lines in numerous countries can increase fixed costs significantly in terms of support services, and a fixed cost structure can be a huge liability in a downturn. Companies must work to understand the full impact that an upturn or downturn could have on its operations, as well as actively plan to manage costs, regardless of the direction the market takes.

Examine efficiency and effectiveness across business processes spanning multiple geographies, products and services to drive sustainable savings.

Over the last seven to eight months, we have seen Oil & Gas and drilling and services companies employ typical short-term cost reduction initiatives such as capital expenditure cuts and SG&A reductions, which include tightening budgets for travel, administrative overhead, and sales and marketing. For instance, rationalizing computer applications is often perceived as one of these “easy” areas. Yet, companies often find themselves spending enormous sums on unexpected ERP implementations a few years later because they suddenly need the capabilities that were eliminated during the cost-cutting process. Time and again, we have seen instances where companies are compelled to undertake significant projects because of prior, short-term decision making. Without a clear path to long-term sustainability, this approach is risky, particularly for companies that are distressed. Tactical cuts that provide immediate savings with a focus on cash flow improvements are critical to short-term survival; however, those that result in deep cuts put future growth and competitiveness at risk.

The current environment offers an excellent opportunity for organizations to make their programs and processes leaner as well as more productive and efficient. The challenge, however, is to differentiate between cutting fat and cutting muscle. This requires thinking strategically and taking a long-term view. Each proposed cost-cutting activity should be assessed by asking whether the moves strengthen the associated business process and provide for sustainable savings.

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In upstream, for example, negotiating a lower day rate on a rig is helpful, but decreasing non-productive time, reducing the number of days a rig is utilized, and incorporating these metrics into the contract increases long-term productivity and makes the savings sustainable. Similarly, reducing maintenance expense through Reliability Centered Maintenance methods and/or equipment segmentation while simultaneously lowering Environmental Health & Safety incidents/exposure, improves a company's risk profile while making the savings sustainable. In downstream, increasing the catalyst and energy efficiency in a refinery while negotiating lower unit rates on catalyst, natural gas, and energy usage results in sustainable savings.

Include scenario planning aligned with the company's core competencies.

The Oil & Gas industry is a cyclical, capital-intensive business that is impacted by volatile commodity prices. Detailed and thoughtful scenario planning that takes into consideration the effects on individual business lines and the company's overall operations if prices drop or spike is what the best performing companies do. The objective should be to determine what actions can be taken to capitalize on or mitigate adverse effects of these swings. A key element of sound scenario planning involves establishing leading indicators such as forecasted commodity prices, implied volatility from option prices, and embedded inflation expectation in long-term interest rates. By monitoring these indicators, a company can spot market trends and act accordingly to position itself for growth or weather a drop in commodity prices.

Most Oil & Gas industry participants already engage in scenario planning to some degree; it is most effective, however, when multiple scenarios are tested to establish a core set of actions that work well regardless of the scenario. This set includes activities aimed at deploying capital against the highest value opportunities while creating the lowest possible, scalable, and flexible cost structure. For example, one of the most important tasks for an Oil & Gas company is to replace reserves. Regardless of market conditions, the most successful companies are always seeking to reduce finding and development (F&D) costs, increase the exploration success ratio, and minimize the time from "prospect" to "production" — and they have a disciplined countercyclical strategy on asset acquisitions.

Establish a cost reduction playbook to ensure effective execution.

The playbook is derived from scenario planning. It should incorporate the issues we have discussed here. It should be highly specific, taking into account which levers to pull, when to pull them and under what conditions.

For instance, the ongoing health of a company often determines which cost reduction levers will have the most impact. If a company is in crisis, then the levers of SG&A, cash flow and even financial restructuring often make the most sense. However, if the company is weathering the storm, and considers itself healthy, then the levers will differ significantly. The focus instead should be on aligning costs with strategy through revenue enhancement, process improvements and targeted, rather than "across-the-board," SG&A reductions.

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While it is not possible to have a playbook for every possible scenario, simply undertaking the development of a detailed playbook for extreme and middle of road scenarios will reveal a number of critical levers and interrelationships necessary for adequately undertaking situations not covered in a playbook.

Structure the management and accountability from the top.

C-suite executives must be fully committed to cost reduction efforts if they are to be both effective and sustainable. Like any enterprise initiative, a cost-management program must be driven from the top and executed bottom-up in order to ensure consistency and alignment with the company's long-term strategy. C-suite commitment is also essential for securing employee buy-in throughout the organization. At a minimum, the CEO and the CFO must be absolutely committed to looking at risk, operational costs, and growth and sustainability across all areas of the company, including all regions, product lines, and service lines. This helps to ensure that cost reduction and productivity enhancement measures – and therefore the pain and the gain – are allocated equitably.

Commodity Prices are Erratic; Cost Reduction Programs Shouldn't Be

Many companies today are forging ahead with short-term cost-cutting activities without adequately considering the dangers of two worst-case scenarios. In the first, the economy recovers and prices rebound to the record highs of 2008. This, however, could pose a significant risk to those that have cut costs and CapEx with undue zeal. These companies will not reap the benefits of an upturn and their market capitalizations will decline relative to their peers. In the second scenario, the economy declines further and prices decline to less than \$40/bbl. In this situation, those that have not made their cost structures more flexible and have not aligned them with their long-term strategies will be faced with selling assets or getting rid of business units at depressed prices.

A variety of scenarios could occur between these two ends of the spectrum. To be prepared for all of them, companies must take a thoughtful, balanced approach to enterprise cost management. This requires developing sustainable cost reduction programs that are aligned with future strategy. Following the whims of the market is an old habit that must die if Oil & Gas companies are to continue to generate value for their shareholders and remain relevant in meeting the world's growing demand for secure, affordable and environmentally responsible energy.

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