

Succeeding amid uncertainty: A preview of the years ahead

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EVEN AFTER FIVE years into the oil downturn, energy pundits and company strategists are still figuring out how to emerge stronger and better in this uncertain business environment. The industry's long march to recovery has created an imbalance across the entire O&G ecosystem

and performance gains continue to be discounted by investors. What are the challenges faced by all segments in the O&G value chain, where both strategy and execution have struggled? How can O&G companies overcome them and succeed in these uncertain times?

Although many industry pundits have provided piecemeal perspectives across the phases of the downturn and recovery, a consolidated analysis of the past five years and a complete perspective covering the entire O&G value chain could help stakeholders—from executive to investor—make informed decisions for the uncertain future.

With this in mind, Deloitte analyzed 843 listed O&G companies worldwide with a revenue of more than US\$50 million across the four O&G segments (upstream, oilfield services, midstream, and refining & marketing) in an effort to gain both a deeper and broader understanding of the industry. The ensuing research yielded a six-part series, *Decoding the O&G downturn*, which sets out to provide a big-picture reflection of the downturn and share our perspectives for consideration on the future.

In this **final part** of the series, we provide a probable preview of the future and discuss how companies can transform in uncertain times.

The (challenging) context matters

A detailed review of the past five years can provide a preview of the future. Our review of the past five years of the downturn has highlighted some of the industry’s shortcomings; we call these the five Cs—core, capital, capability, contractual frameworks, and confidence (figure 1).

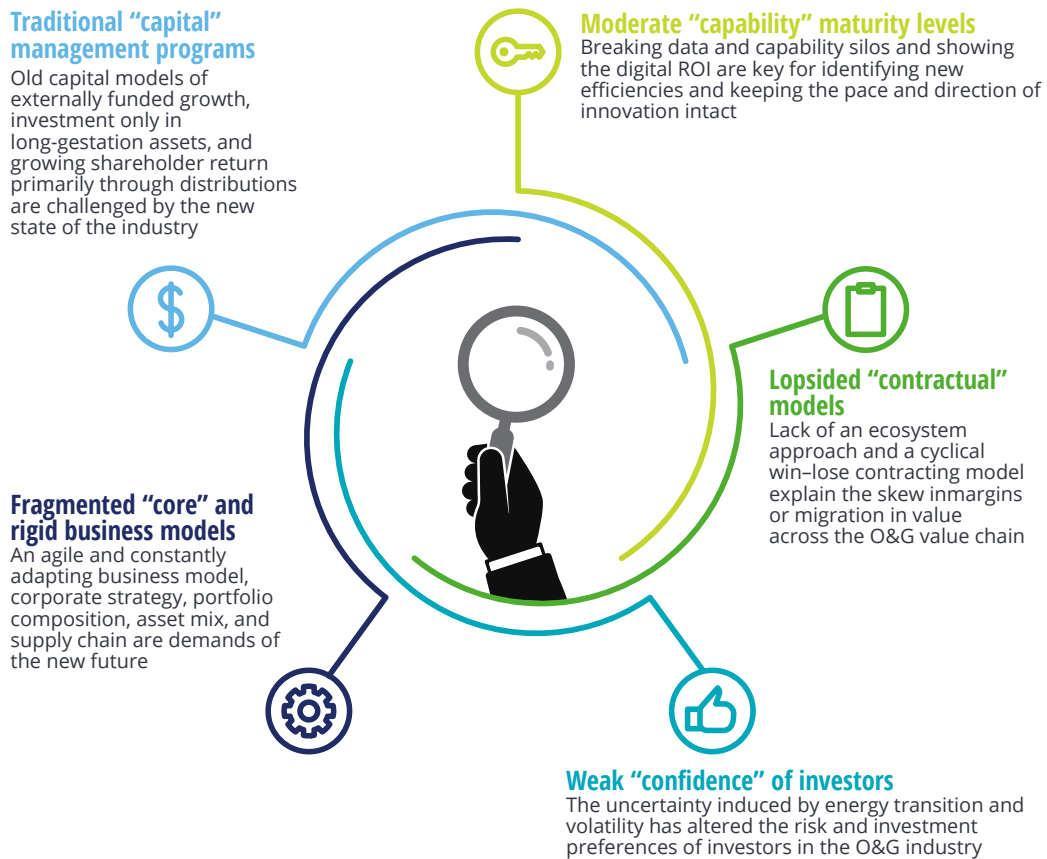
- **A fragmented “core” and rigid business models:** A less agile and inflexible business model, corporate strategy, portfolio composition, asset mix, and supply chain seem to be inhibiting the future of O&G companies. Whether it is the hidden inefficiencies in the portfolio of

producers or the lack of a cohesive integration strategy of oilfield service majors, the O&G industry still has a long way to go in making its core future ready.

- **Traditional “capital” management programs:** Shale producers’ outdated capital management strategies of growth at any cost, integrated oil companies’ conservative investment agenda, midstream’s externally funded growth, and downstream’s cyclical overinvestments (the global refining sector is projected to add 2.6 MMbbl/d of new capacity in 2019, its largest annual increase since the 1970s¹) are all creating imbalances in companies’ books and limiting regular assessment of new priorities and opportunities.

FIGURE 1

The context matters



Source: Deloitte analysis.

- **Moderate “capability” maturity levels:** Although the overall numbers suggest that the industry hasn’t completely taken its foot off the pedal of innovation and hiring, falling R&D spend of integrated oil companies (IOCs) and lower output per unit of labor of national oil companies (NOCs) appear to highlight the mismatch in the long-term strategies of the two biggest owners of O&G supply.
- **Lopsided “contractual” frameworks:** A cyclical win–lose contracting model between producers and oilfield service companies and producers and midstream companies can explain the skewed margins and lopsided relationship between segments during the downturn. Old contractual models should evolve and remain in sync with the changed profile of investment (from long-cycled to short-cycled), supply (under to over supply), and risks (from mainly sub-surface to increasingly above-ground) in the industry.
- **Weak investor “confidence”:** Growing shareholder returns, primarily through dividends and share buybacks, haven’t yielded expected results, leading to undervaluation over the past two years (in fact, the O&G industry is valued lower than the replacement cost of its assets). The uncertainty induced by this lower-for-longer and volatile price environment has altered the risk and investment preferences of many investors in O&G companies, where they are not only demanding higher hurdle rates but also expecting consistent performance across cycles.

Would a favorable future help O&G companies overcome these shortcomings? What does the future look like and how can companies across the O&G value chain prepare and transform?

The uncertain future

Although oil prices seem to have bottomed out as of early 2019, a slew of economic and industry

data suggests a significant impact on oil and gas in 2019 and 2020, on both the supply and demand side, which could be either bullish or bearish for prices. Briefly put, volatility appears here to stay.

- **Robust economic growth, though downside risks are emerging:** After the global economy grew at a robust pace in 2017 and 2018, growth is expected to be moderate in 2019 and 2020 due to heightened political risks, rising trade tensions, and weakening currencies and slower growth in emerging economies.²
- **Involuntary cuts balance out, while OPEC-led compliance seems at risk:** Involuntary cuts in Venezuela and Angola have helped OPEC reduce oversupply in the oil markets, but the question about how long production restraint compliance can continue remains. Additionally, there are concerns that OPEC and its Vienna Agreement allies (led by Russia and Kazakhstan) could drift apart on the agreed cuts for 2019.³
- **Oil prices seem to have found a floor, but volatility has returned:** Although oil prices remain above US\$50/bbl (WTI)—a physiological and economical threshold for US shales—volatility in prices increased in the last quarter of 2018. On a weekly basis, prices have swung by 8–10 percent over the past six months.⁴
- **OPEC’s moderate spare oil capacity amid rising shale well inventory:** OPEC’s spare oil capacity, heavily influenced by the organization’s compliance, remains at a moderate level of 2.4 MMbbl/d, while the number of drilled but uncompleted shale wells in the United States crossed 8,500 in December 2018.
- **Disciplined investments raising under-investment concerns:** Although moderation in capex has strengthened the balance sheets of O&G companies, decline rates of maturing conventional wells (both in the United States and globally) have risen significantly. Brazil’s Campos Basin, for example, has registered a 30 percent fall in its production over the past five years.⁵

- **Financials of companies improving but new segmental shifts emerging:** O&G companies have never seemed as efficient as they are today due to their laudable work on the productivity and cost front. However, the migration of value and margins across the O&G value chain remains highly skewed, with vulnerabilities now emerging in downstream (especially on the gasoline front).
- **Permian and LNG driving growth, but infrastructure bottlenecks persist:** Infrastructure constraints are capping near-term production growth potential of both the Permian in the United States and large-scale LNG expansion worldwide.⁶ Energy infrastructure, especially outside the United States, remains underinvested and monopolized, and faces several contracting issues.

Winning in uncertain times

Even after five years into the downturn, the industry remains in transition and the period of transformation continues for companies. How can companies overcome their challenges (the five Cs mentioned earlier), to set themselves up to succeed in uncertain times?

- **Strategically and tactically work on the “core”:** Upstream companies have made headway divesting peripheral assets, but other segments remain focused on consolidation rather than optimization. For many companies, strengthening their core will likely require companies to right-size their portfolios, renew focus on operational excellence, centralize project delivery across the company, and transform their business models. Across the O&G sector, companies should assess where their sole competitive advantage lies, and where they are better off partnering with peers/vendors.

More importantly, companies should emphasize flexibility, to prepare for both upside (from underinvestment) and downside (from macro concerns) risks. The right answer could vary by segment and by company. While many

onshore US service companies should focus on increasing scale and scope as it will likely improve their performance, other companies such as shale-focused E&Ps may be better served by high-grading their acreage and only drilling the best wells.

Clearly, mergers, acquisitions, and divestitures are expected to play a key role in streamlining portfolios, but tactical decisions could be as important as strategic ones. Removing excess layers and processes from the supply chain can cut costs, and in the case of a merger, economies of scale lend themselves to cost reduction and process integration. Similarly, as organizations grow (or shrink), the organization should flex as well, with key roles reimagined amid new corporate processes.

- **Embrace dynamic “capital” management programs:** The entire O&G sector seems to have struggled to balance revenue, capital expenditure (capex), and operating expenditure (opex). The importance of right-sizing portfolios is not just operational, but also financial. Companies should push to increase variability in costs to better align with variability in revenue. Flexible contracting can certainly help, as could lease-back agreements for high-cost equipment. However, the challenge remains that many large investments would have to be upfront (e.g., frac fleets, pipelines, refineries) in a cyclical business environment. Thus, diversification in some form has its own benefits.

For some, diversity could mean investment in new energies such as solar, wind, and biofuels. For others, it could be the diversity of financing, augmenting public equity and debt issuance with private equity project co-investment, alternative structures (e.g., DrillCos), and cross-segment cost sharing. Sustainably balancing the books in a volatile business would require companies to assess all options, and combine various financial strategies to reduce costs, while increasing revenue to generate higher total returns.

- **Build new and differentiated “capabilities” with an eye on digital ROI:** Across the industry, R&D leaders should emphasize the ROI of investing in new capabilities—whether

that is partnering with technology firms, expanding R&D investment, or reorganizing centers of excellence. This can also allow some segments/company groups to double-down on differentiation and connect their wealth of data and specialization with others in the ecosystem.

OFS companies, for example, specialize in working with many companies and they could position themselves as leaders in analytics and platforms that can be readily adapted to clients' rapidly changing needs. Midstream and downstream companies, on the other hand, have had a long history of using digital tools, but it might be imperative that they link their operations with the larger markets through advanced analytics, allowing them to be in sync with shifting regional supply and demand balances.

- **Adopt outcome- and performance-oriented “contracts”:** Typical agreements between different segments share the risks and rewards to differing degrees, ranging from one-off turnkey contracts to long-term value-based payouts. During the downturn, it has been evident that service companies and, to a lesser extent, E&Ps have borne the brunt of the impact. Lower revenue, through either lower commodity prices or downward renegotiated pricing, combined with lower utilization, and remaining fixed costs, has hit the bottom line more severely than the top line. Midstream companies using take-or-pay contracts, as well as integrated downstream firms who were able to control margins, have fared better.

In all cases, there is an argument for increased use of performance-oriented contracts, and increased risk-sharing. That provides incentives for improved performance, while reducing the impact of cyclical price downturns on one particular segment. However, there are limitations to consider. For example, debt financing in some circumstances may limit payout variability for gathering and pipeline operators. Moreover, companies pursuing high-risk, high-reward

strategies may be averse to profit-sharing agreements. Nevertheless, a healthy oil and gas ecosystem requires healthy business segments, and the asymmetric impacts of the downturn seem to highlight the need for better contractual management of revenues, costs, and risks.

- **Regain investor’s “confidence” through a compelling narrative:** A narrow, thinly executed transformation program of O&G companies based on a limited perspective on the future has undermined investor confidence in the O&G industry. Our analysis of several investor presentations suggests that today’s investors aren’t just following oil price cycles to time their investment, they also expect flexible short-term and compelling long-term strategies that are based on a wider set of disruptive possibilities.

Meeting these expectations requires O&G companies to optimize their financial and strategy disclosures and give early and deeper thought to the probable pain areas highlighted by investors during investor presentations. Additionally, O&G companies, especially with a large and diversified portfolio, shouldn’t shy away from talking about carbon emissions, sustainability, and even their view on renewables and investment in new energy (something that is proactively and consistently done by European supermajors, which have also outperformed other IOCs over the past five years). A detailed, transparent, and compelling view is what investors often need to build a long-lasting relationship with a company.

In the past, an eventual upswing in prices benefitted everyone, even those that had the highest breakevens and/or were the least efficient. But the new age of abundance, lower prices, and rising volatility could challenge the strategies and performance of even the best companies in the industry. Chasing the cycles or making piecemeal adjustments may not be winning options anymore. Explore the entire [Decoding the O&G downturn](#) series to gain a 360-degree view on the industry.

Endnotes

1. Elza Turner, "IEA expects 'challenging' 2019 for oil refining industry," S&P Global Platts, January 18, 2019.
2. Deloitte, *Dark clouds bring rougher seas*, January 2019.
3. Brian Wingfield, Samuel Dodge, and Cedric Sam, "OPEC, allies reset oil cuts. About half are keeping the bargain," Bloomberg, February 19, 2019.
4. US Energy Information Administration website, accessed March 6, 2019.
5. Catherine Ngai, "Mind the drop: Decline rates from maturing oil wells on the rise," Bloomberg, October 9, 2018.
6. Bassam Fattouh, *OPEC cycles and crude oil market dynamics*, Oxford Institute for Energy Studies, October 19, 2018.

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