

Responding to shale's pressure test in 2015

Beware of unintended consequences

The EY logo is positioned in the bottom left corner of the page. It consists of the letters 'EY' in a bold, white, sans-serif font. The background of the entire page is a photograph of an industrial wellhead in a desert environment, with a large yellow diagonal graphic element on the right side and a white vertical bar on the left side.

Building a better
working world

Smart unconventional companies take a multidisciplinary approach to analyzing cost reduction plans, using data and analytics to understand the full impact of their choices.





When crude prices fall, it's relatively easy for oil and gas companies to cut costs. Squeeze suppliers, reduce headcount, shut down high-cost projects and slash capital spending – most senior executives have the drill down cold.

But it is far more difficult to reduce costs in a structured manner that takes into account the cross-functional impact of each action. Even the most sophisticated oil and gas companies rarely take a holistic, analytic view of proposed cuts to determine the unintended consequences of their actions while giving every key leader a seat at the table.

Every cost-cutting move taken today will have some impact beyond reducing spending. Some will have long-term effects that will damage the company's ability to thrive today and grow tomorrow. This is especially true of companies involved in unconventional exploration and drilling, where being nimble pays off.

To date, 2015 has been an unprecedented pressure test for firms involved in unconventional production, and many companies have already made significant cuts. But relief may be many months away, and if the price of crude oil stays in the US\$50-\$60 range for some time, shale companies may have to revisit their cost structures once again and look for ways to reduce spending. The smart companies will approach future cuts with a more strategic view to ensure that they are not hurting their ability to rebound when the price of oil does. The most innovative players will use this as a time to grow and increase their competitive advantage.



Cuts have consequences

The idea that cost-cutting measures have unintended consequences is not something many energy executives consider when faced with declining prices, given the “just stay in business” mindset. Historically, companies have cut as needed to ensure survival, with the idea that whatever was eliminated could always be added back when necessary.

Today, most cost-cutting is still done in a siloed fashion, with each function being given a target to cut (either costs, headcount or both). The lack of multidisciplinary input leaves many executives still believing that if they cut US\$100 in costs, the company will have an additional US\$100 in cash.

But consider what happens to companies that scale back on drilling plans in a given year to conserve capital and cash outlays. When drilling is curtailed, so are indirect drilling costs, which allow exploration and production firms to delay taxes. So the company could end up owing more in taxes than previously anticipated; a US\$100 in cuts could net only US\$65 after taxes.

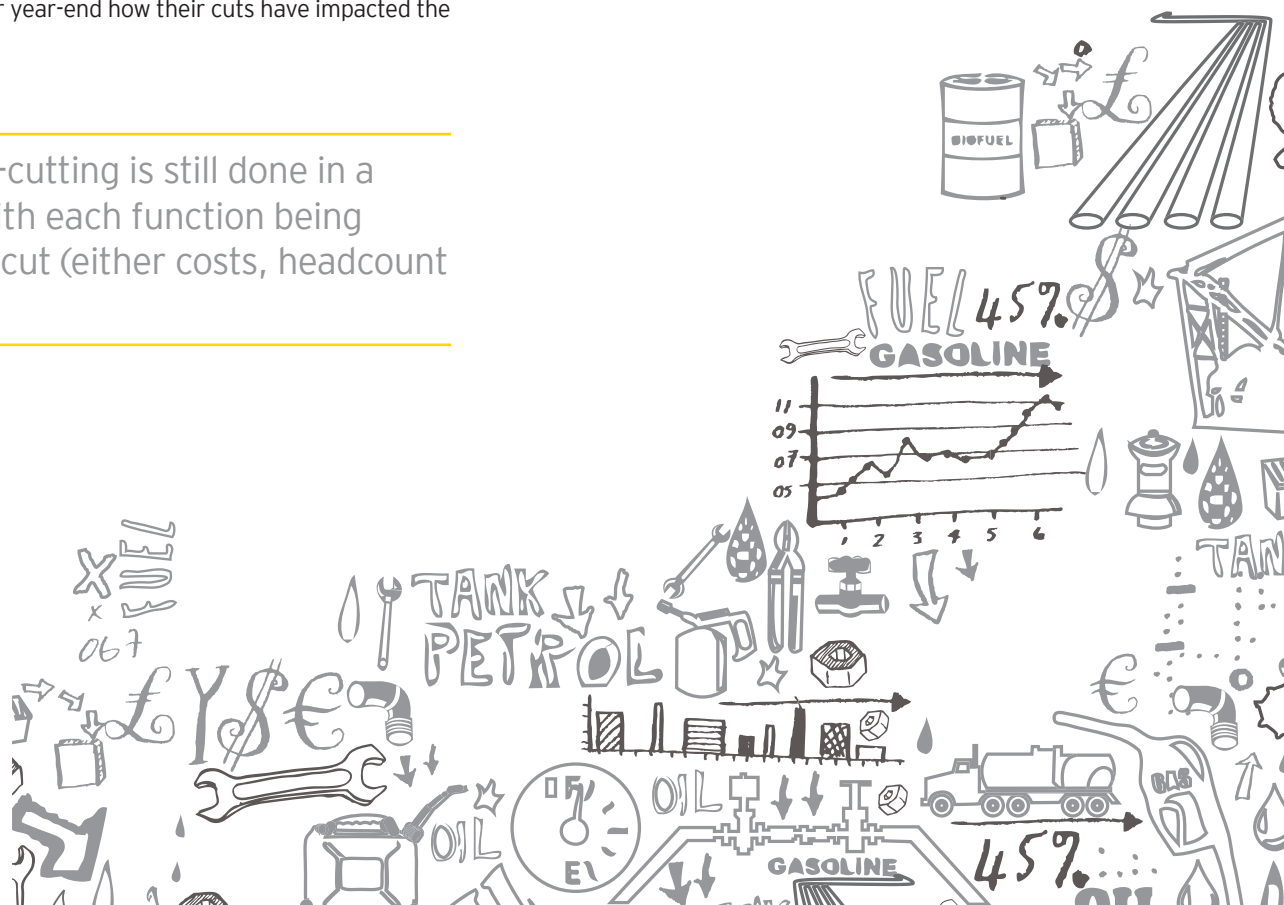
In fact, because the tax function is often reactive to budget cuts rather than being involved in the planning; most executives don't realize until quarter-end or year-end how their cuts have impacted the company's tax liabilities.

Cuts in spending could lead to potential reclassification of reserves, having a negative impact on the companies' capital.

Another example of unintended consequences relates to talent. Unconventional companies that let go skilled workers with expertise that will be needed later may find the talent has left the industry or is now employed by a competitor. As the industry experienced after massive layoffs in the 1980s, gaps in the talent base can have a significant impact in later years. Additionally, a loss of people often results in a loss of some internal controls that reduce and detect non-compliance with policies and procedures. “Fewer eyes” can lead to undetected risks and loss of precious capital.

Rapid reductions in spend have also led to a large inventory of drilled but uncompleted wells and significant idle asset capacity waiting for profitable job opportunities. These buffers will lead to a flood of work when players reboot.

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Multifunctional approach

To eliminate unintended consequences, smart companies will manage future cost reductions through a disciplined, multifunctional approach in which proposed cuts are shared and studied to determine their full impact, in both the short and long terms.

These reviews should incorporate representatives from:

- ▶ Operations
- ▶ Commercial
- ▶ Finance
- ▶ Tax
- ▶ Legal
- ▶ Human resources
- ▶ Safety and environmental
- ▶ Public relations
- ▶ Compliance - Internal Audit
- ▶ Other support functions

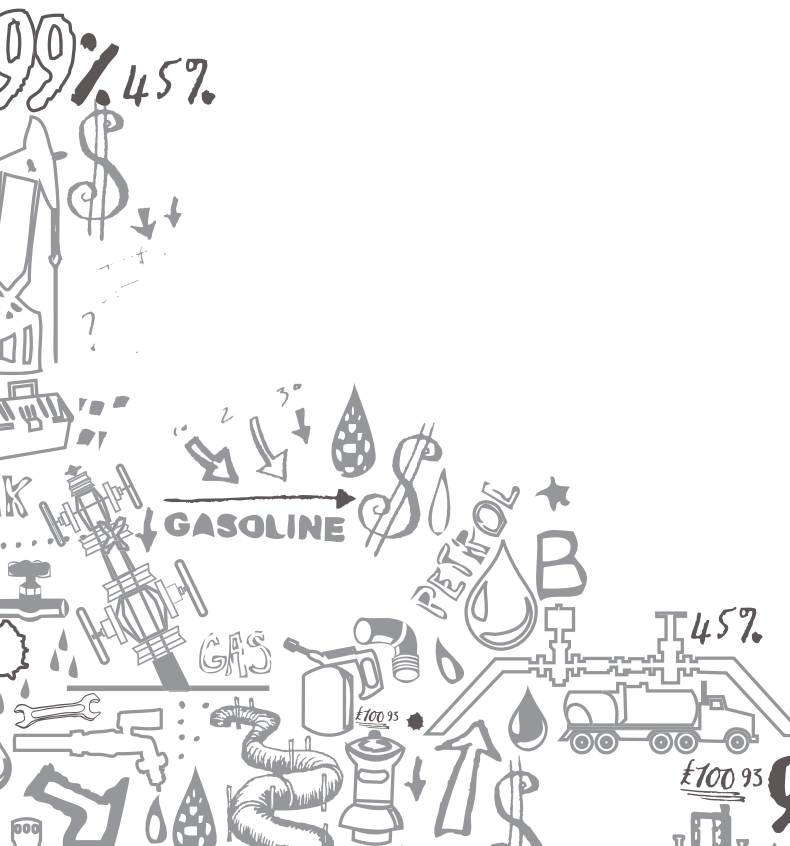
Each of these functions can provide specific guidance critical to understanding how proposed spending cuts or headcount reductions will impact the company; internal audit can help guide the process by facilitating the review.

The goal of this multifunctional review is not to turn decision-making over to a committee. It is to ensure senior managers charged with making decisions about spending and/or headcount cuts have strategic insight into how each proposed move will impact the company.

In addition, risk management can play a role in helping senior executives understand the changing dynamics of the marketplace by stepping up their monitoring and providing more frequent updates, along with response recommendation and mitigation plans. Intensive modeling of scenarios and trade-offs can also help senior managers better understand how cuts in spending will impact the company at difference price points.

To minimize the negative impact of cuts, EY recommends developing a multiphase cost reduction with has various levers which can be “pulled” as needed. While some companies prefer to feel the pain all at once, it is far more effective to trim as lightly as possible and then enact deeper cuts as circumstances require. This also gives the company time to review all potential levers and understand the full impact each one will have.

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Data-driven efficiencies

The old approach of across-the-board cuts was neither strategic nor good for recovery. Today, a smarter method is to look at the expenditures that have the biggest impact on cash flow and profitability, and look for data-driven ways to operate more efficiently – in essence, reducing costs not by cutting but by working more effectively.

EY believes there are five key areas where unconventional companies can adjust their strategy to achieve greater efficiencies and cost savings and increase free cash flow:

Five areas

1 Capital planning and execution: Unconventional exploration and production (E&P) companies should prioritize their key projects for growth and improve controls for cost containment and budget protection. Fine-tuning the company's capital plans makes sense in any cost environment, but it is especially important when prices are low.

2 Operations and supply chain: During downturns, it is not unusual for companies to seek concessions from suppliers and vendors to reduce costs. But these efforts often lead to frustration and bad feelings that can damage working relationships forever. It is far better to work with suppliers to find ways to reduce costs, sharing in the process and outcomes, and then initiate projects to improve process and controls to eliminate go-forward drags on working capital.

3 Portfolio management: Companies should work to align their acquisition and divestiture plans to a new growth plan that is based on current price levels. Shed non-core assets and redeploy that capital into acquisitions that allow you to take advantage of the company's current geographic strengths or skill sets.

4 Workforce realignment: Organizational realignment should be driven by analytics and strategy to ensure that the talent is in place for rapid profit capture upon price recovery. Executives should be wary of plans that recommend across-the-board job cuts or that severely limit the functionality of certain departments or functions, and may open up risks of non-compliance with policies, procedures and regulations.

5 Analytics and digital innovation: Unconventional companies should link project funding more closely to supporting analytics for capital performance management. By using innovative technology, they can drive more efficiency at the wellhead across operators and oilfield services (OFS) teams.



Opportunities for mergers and acquisitions (M&A)

This downturn is different from ones in the more recent past because, for the most part, the capital markets are still open and available to companies in the energy space. In addition, energy companies have access to a wide range of nontraditional forms of capital, such as private equity. In fact, there are many private equity firms with significant amounts of cash looking to invest in the energy sector.

Smart E&P companies—those with good cost structures and good cash flow—can use this opportunity to expand their footprint and strengthen their competitive advantage.

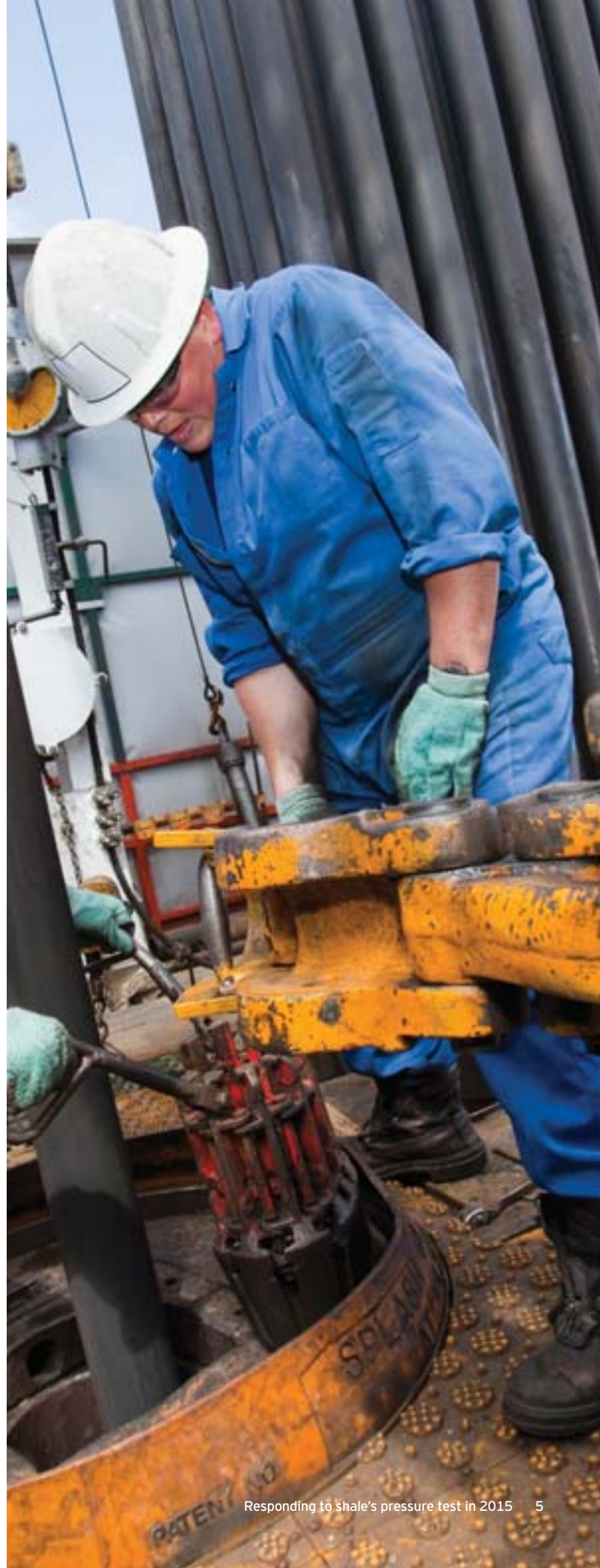
We will likely see even more opportunities for M&As as 2015 becomes 2016, since highly leveraged companies will be eager to sell assets to raise cash. That will also lessen the valuation gaps between buyers and sellers and bring everyone to the table.

Companies that want to strengthen themselves through M&A will use this time to analyze their cost structures and find ways to reduce costs through efficiencies and process changes so they are well-positioned to move forward, should attractive opportunities come available.

EY can help

As the lower-price environment continues, unconventional companies that understand the importance of free cash flow – and how to manage for it – will be best positioned for success when prices rebound.

EY can help unconventional companies evaluate their existing cost structures and identify ways to streamline processes and enhance efficiencies to achieve two critical goals: reducing expenditures to ensure survival today and positioning the company to take advantage of opportunities to thrive in the future. We can work directly with your multifunctional team to help ensure that cost-reduction plans are modeled and analyzed effectively to eliminate any unintended consequences.



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