Is Your Business Based on Hope?

"What decisions would you have made in early 2015 if you suspected oil prices would be $60 today?"

In early 2015, upstream oil & gas leaders were predicting a "V"-shaped price recovery and maintained capacity for the expected upturn. But by June, they were grudgingly slimming down based on predictions of a "U"-shaped recovery. Now, IOCs are basing their plans on "Lower for Longer". A whole industry has cropped up to predict when prices will go up with very plausible and well thought out arguments. Yet questions remain. What went wrong? Why didn't history repeat itself?

It is instructive to look at the power industry for an example of a dramatic business environment change. In Europe, incentives encouraged growth in wind and solar power to the point where many power plants were no longer needed Electric utilities consequently saw a rapid decline in equity values. In North America, independent power producers have been similarly decimated as they continued to deny the realities of the market. What failed? The incumbents and regulators proved incapable of seeing a world beyond their historical reality.

Few foresaw the success of unconventional oil & gas ten years ago. The resulting supply shock coupled with sluggish demand growth has driven an industry reset. However, we are not here to pit our reputation on a price forecast. Rather, we would like oil & gas companies to move from "hoping for better times" to considering the likely scenarios that they need to prepare for.

What decisions would you have made in early 2015 if you suspected that oil prices would be trading around $60 in 2017? Would you have cut back spending more quickly? Shed unprofitable business? Sold divisions to more bullish investors?

Unfortunately, most business plans and strategies are based on a single-prediction of future prices and demand. As a result, organizations frequently fixate on the business plan and are slow to adjust to material changes in the business environment – both up and down. An alternative approach is scenario planning, where a number of plausible scenarios are modeled and plans built for each scenario.

In fact, the oil industry has pioneered scenario planning. Shell has its *Mountains* and *Oceans* scenarios. BP, Exxon, and EIA and others have coined other scenarios, that are often very thought provoking. However, few oilfield participants can afford (or need) the cost or time of comprehensive scenario planning.

Prescription for the Upstream: Major oil companies are now predicting "peak oil sometime in the next 10 years." The panacea of relentless demand growth is likely to disappear and the oil industry will have to change from waiting to make money in the peaks to becoming fundamentally competitive across price cycles.

Short-Term Solution: Most operators eliminate the price-risk to their business plans by hedging output. Unfortunately, it's not that easy for service companies to de-risk their one to three-year plans. Rather, we suggest that, as part of each planning cycle, business units and companies use a half-day (or more) offsite to:

- develop a set of plausible scenarios;
- establish the signposts that indicate a different scenario is in place;
- identify the profit maximizing actions to be taken when operating within the scenario;
- agree upon the no-regret moves common across all scenarios.

For example, the (highly simplified) output of a scenario offsite might look like this:

- Scenarios: Base case is $60 oil, the low and high scenarios could be <$50 and >$70 oil.
- Signposts: Oil prices must stay within new range for two weeks.
- Actions (high price scenario): Authorize additional capital and additional manpower in sales, services and manufacturing.
- Common Moves: Streamline accounting processes and install new system upgrade.

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By investing just a few hours, leaders can move more quickly to proactively maximize value rather than miss opportunities by reacting to change after the fact.

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Lion & Stutz is dedicated to assisting energy companies achieve their full potential.