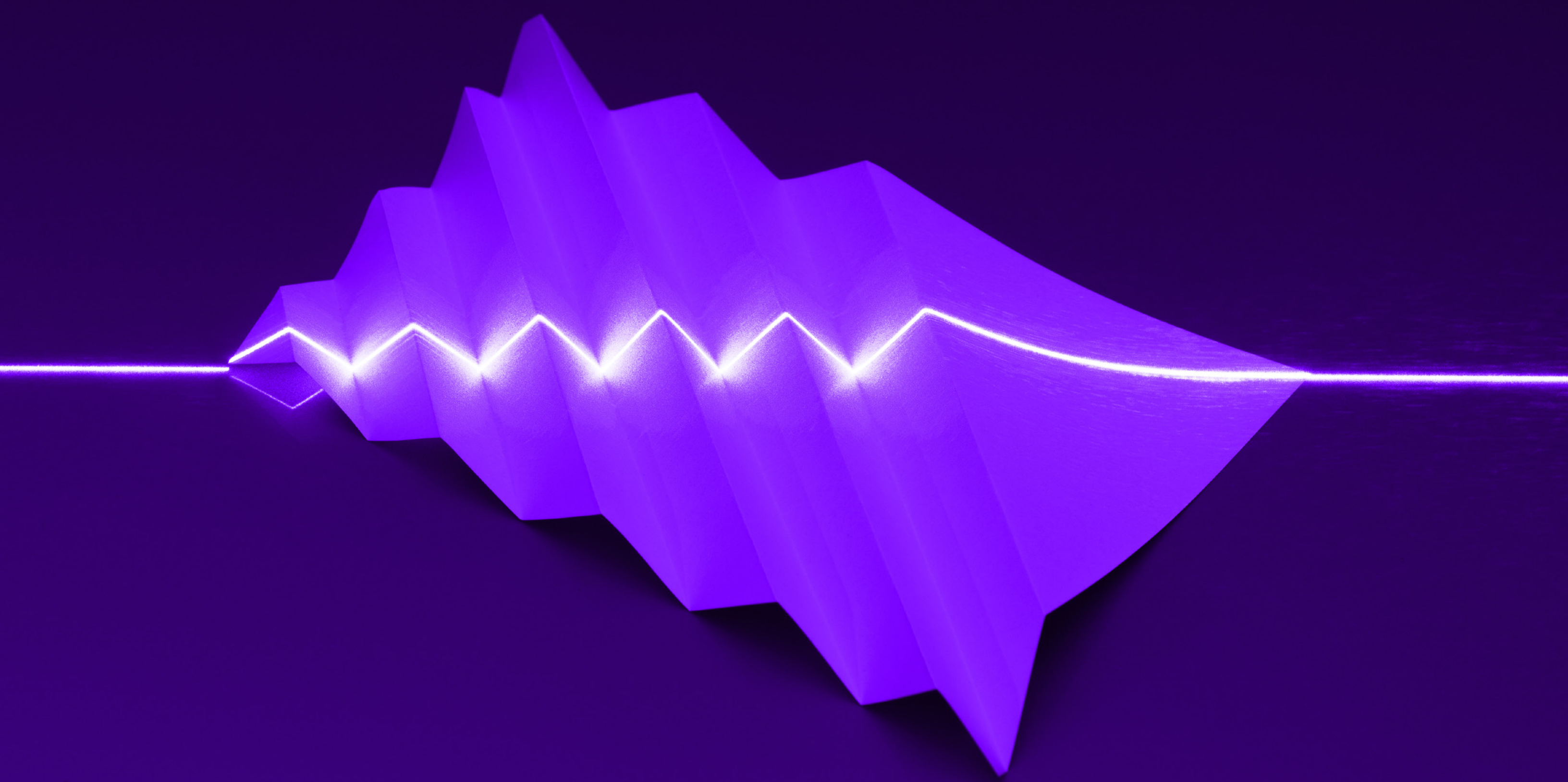
accenture

THE ONE-TWO PUNCH FOR OIL MARKETS

What concurrent supply and demand shocks mean and how to respond



Muqsit Ashraf, Manas Satapathy, Vivek Chidambaram

The oil and gas (O&G) industry is no stranger to supply and demand shocks, having faced more than a dozen such jolts over the course of the past four decades.

Most of the supply side shocks, excluding 2014's bump, were the result of sudden supply pullbacks in reaction to geopolitical unrest. On average, the impact these market-tightening shocks made lasted anywhere between one and six months. Demand-side shocks were largely due to macroeconomic contraction and have been closely connected to larger volatile economic cycles—in terms of size and duration.

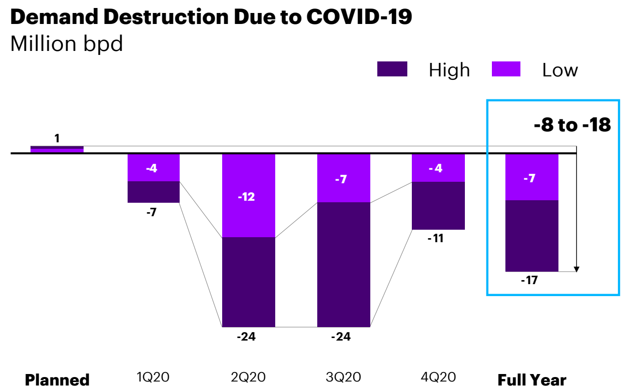
Despite the shakeups the industry has experienced over the years, however, recent events portend a new and perhaps even more disruptive market:

- A black swan event, COVID-19, is driving a demand-side shock that's still rippling through the global economy. We estimate that hit to be approximately between 8 to 18 million bpd through the end of 2020 versus planned (Figure 1). Overall, we expect global oil demand to be lower in 2020 than last year, which hasn't happened in more than a decade.

- Meanwhile, we're seeing a concurrent supply-side shock stemming from OPEC+ and engulfing North America, a marginal supply source. Saudi Arabia is planning to open the floodgates on oil supply precisely when the economy is preparing for a contraction.

Figure 1

Demand destruction due to COVID-19 is shaping to be massive – full year 2020 demand could be 8 to 18 million bpd lower than planned



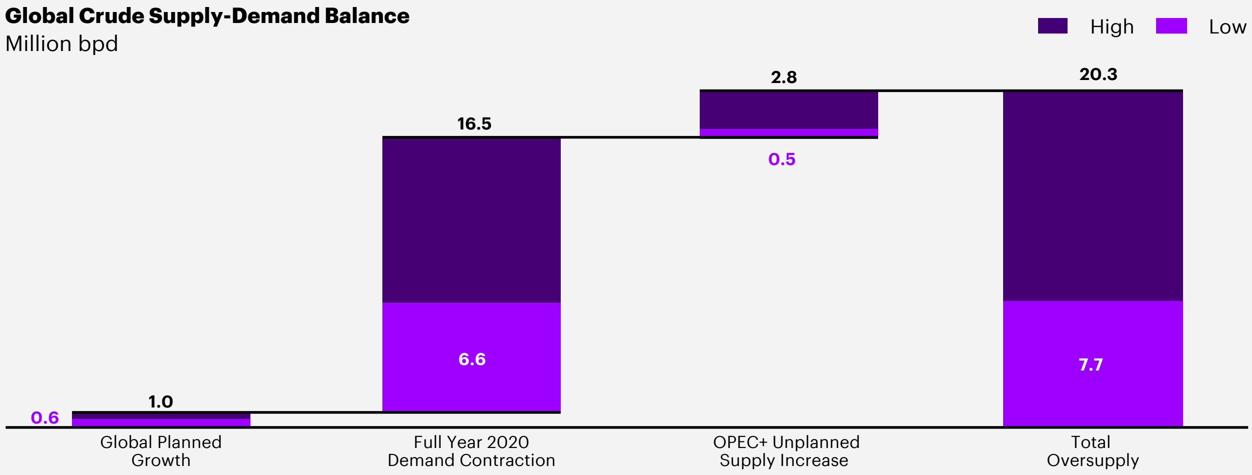
Source: Accenture analysis.

- About 60 million bpd is used in transportation – road, sea and air.
    - A 20-40% contraction in transportation in Q2 is 12-24 million bpd reduction in crude oil demand
- A global recession will put further pressure on the remaining 40 million bpd of non transportation demand

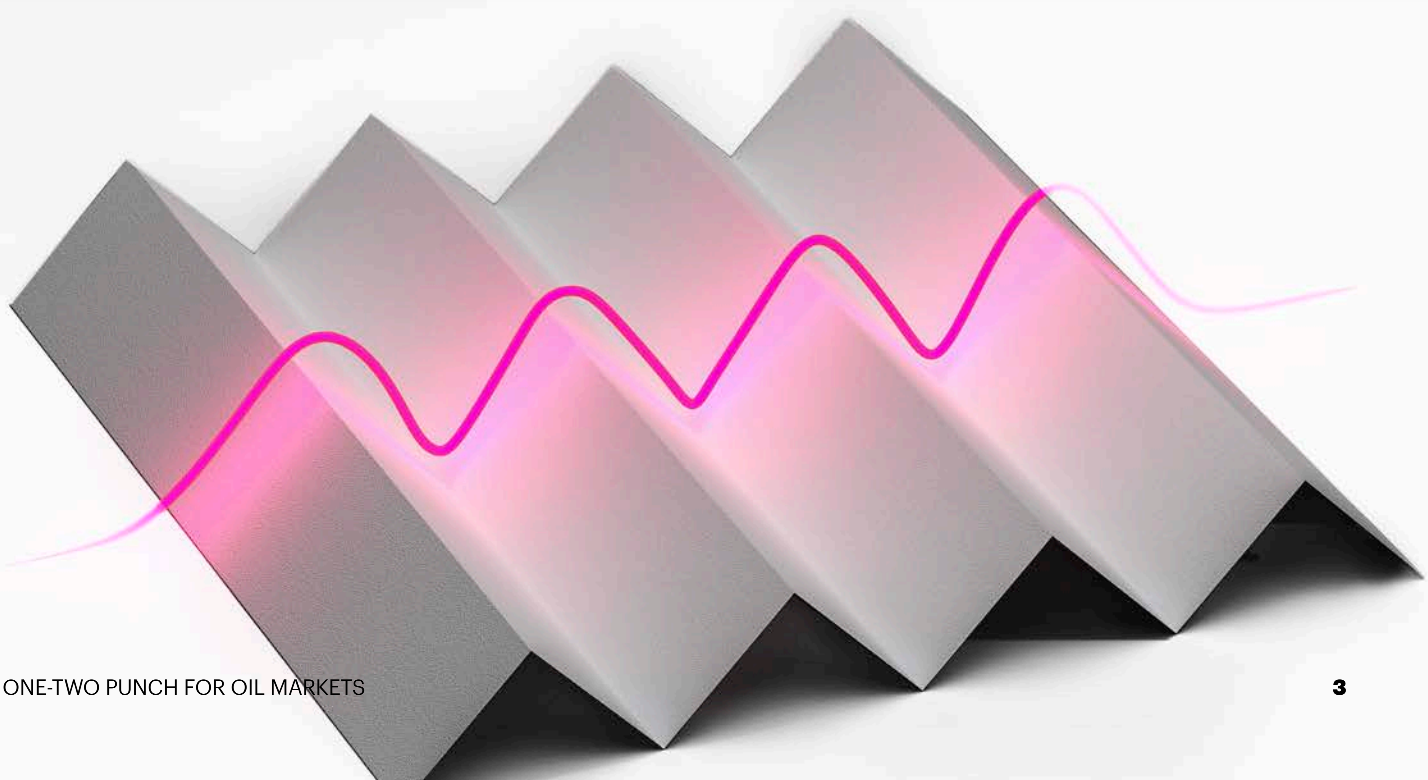
The confluence of these two shocks creates an unprecedented situation—hence difficult to predict—but if we piece together the various elements of supply and demand in light of these events, it appears that the impact could last well into 2021 (Figure 2) with a disproportionate impact on US production. However, it is safe to say that we are in for a turbulent 2020, and a lukewarm 2021 in which commodity markets will be under pressure, and it's hard to see any winners at this time given the looming recession. Producer nations, investors, O&G companies themselves, and green/new energy businesses stand to lose.

Figure 2

Crude oil S-D balance facing a "Double Whammy" – Resultant oversupply can lead to very low prices in the short run



Source: Accenture analysis.

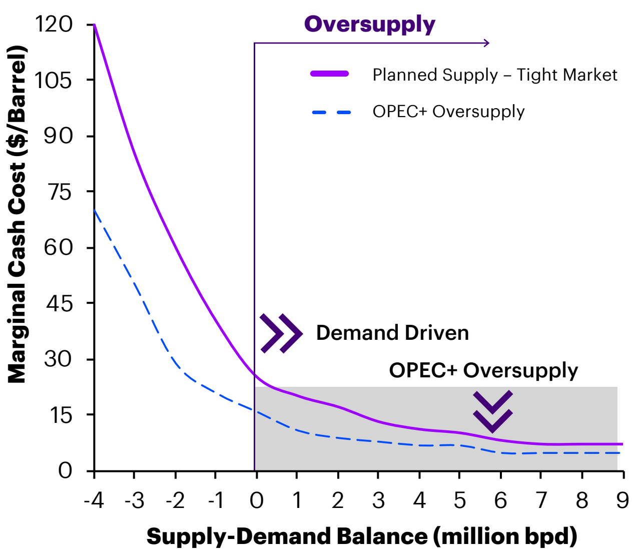


What's different this time around?

Simultaneous demand contraction and a concurrent ramp-up in supply is unprecedented. We are in uncharted waters, and it isn't clear who will win this game of brinkmanship. We expect current low prices to prevail and quite possibly drop even further if OPEC+ continues the flood-the-market stance given the demand destruction and resulting oversupply (Figure 3).

Figure 3

Oversupply without OPEC+ cuts can push prices to very low levels in the short-term

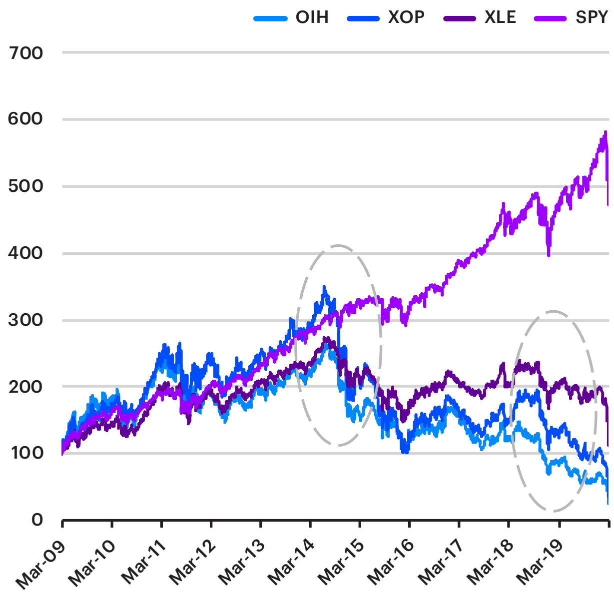


Source: Accenture analysis.

The O&G industry was already in a state of disruption leading up to these events. Sector returns were under pressure, capital was flowing out of the industry, and decarbonization headwinds were strengthening to capital increases. North American operators in particular were in a more precarious position than they were in 2014. Capital availability had almost dried out—investors were cheering capital cuts and penalizing capital expansion. Oil stocks were being hammered across the board and were even below 2014 levels (Figure 4).

Figure 4

Oil and Gas Exchange Traded Funds Indexed Returns



Source: Thomson Reuters, Accenture analysis.
OIH = Oilfield Services; XOP = E&P; XLE = Energy;
SPY = S&P

Additionally, resources became more abundant, the market more competitive and alternative energy sources more prevalent, pulling the bar lower for alternatives to specific sources of O&G supply. Finally, the downstream sector that served as a cushion in 2014/15 for the industry at large, for pure play refiners, and for international oil companies (IOCs) as a result of improved margins will not be a savior in this cycle – the potential for higher margins will be blunted by reduced volumes as a result of the economic contraction.

What will still remain the same?

Despite chatter about peak O&G markets and until recent events threw the market into a tailspin, the demand for both oil and gas was growing. Also, once the global economy stabilizes there's no indication that growth won't return as the world still needs oil and gas to sustain development and drive prosperity in the developing world, not to mention meeting the needs of an estimated 2+ billion people who'll join the global population.

Also, while the economics of O&G extraction have improved considerably since the last supply shock in 2014—by up to $10-$20 per barrel—ultimately the full-cycle breakeven economics of the marginal barrel will set the equilibrium price. And that breakeven price is still in the high $50s to low $60s per barrel. Markets can stay irrational temporarily, but ultimately fundamentals will prevail.

Challenging times require an intelligent response

Despite the inherent volatility of the commodity markets, we find O&G companies are often ill-equipped to deal with major demand or supply shocks. With the ongoing disruption coming in the wake of the one-two punch of the demand and supply shock, the first set of actions should be around fortifying the organization for any eventuality—i.e. building resilience. These actions should focus on steadying cash flow, reducing costs, and securing revenues.

A roadmap for CEOs

We see five critical steps companies can take now to build resilience:

1. Set up a 24/7 virtual command center to keep a pulse on the market and dynamically stress test the business

- Generate or access potential market balance/price scenarios, and identify leading indicators associated with each scenario to trigger actions ahead of time. Signals on the demand side can include readings on industrial activity (PMI) and travel and retail data, and on supply-side CapEx plans and discussions around off-schedule OPEC meetings.

- Put business continuity plans and cash flow to a rigorous stress test under various scenarios focused on identifying key gaps and shortfalls over a three-, six- and 12-month period. Coupled with indicators tied to the potential scenarios, this should form the basis of a risk register that can become a company's response playbook.

2. Fast track competitiveness—Zero-base everything rapidly

Launch a data- and advanced analytics-driven program, leveraging a battle tested AI tool to quickly scan and assess spend and generate insights from efforts within and across the industry. Challenge every cost, spend item (third party or internal), investment decision and supply arrangement. Ask "why is this needed" rather than "how can we reduce it." This will create a clean sheet with no "sacred cows," sustainable over time without impairing the business's ability to grow when the cycle turns.

3. Improve liquidity by rethinking and rebalancing capital spend and portfolio

Prepare to make changes dynamically as there will be considerable volatility over the next several months, and portfolio decisions will need to change accordingly. This involves three crucial steps:

- **Step 1:** Surgically assess every asset, capital spend and new business decision to reflect the new reality—namely, lower and more volatile commodity prices.

- **Step 2:** Evaluate all options—stress test marginal assets and evaluate all new investment decisions with a higher bar for risk. Return and identify optionality to idle, defer and consolidate assets and/or investments. The objective is to solve for shorter cycle or a more flexible investment profile.

- **Step 3:** Update all CapEx and OpEx plans for the next 6, 12 and 24 months. It is important not only to reduce new CapEx, but also to investigate all opportunities to improve the effectiveness of OpEx. Judicious spend on OpEx (or maintenance CapEx) can lead to quicker and higher returns than on new CapEx.

Reevaluate all decisions about growing the core business and scaling new businesses—what makes absolute sense to pursue or keep unchanged through this cycle versus deferring without affecting long-term prospects and objectives.

4. Unlock operational and commercial resilience

Review offtake and supply/service agreements and hedges to identify optimal monetization options and favorable contracts to carefully manage through the cycle. Reinforce partnership and commitments to key customers through concessions and flexible arrangements.

5. Plan and prepare for the worst-case scenario

Develop contingency, restructuring and quick divestment options, identifying alternative sources of funding and private market access. Look to other industries that have been in similar circumstances. For example, look at the automotive industry's 2001 post-9/11 "Keep America Rolling" initiative. Similarly, the retail industry faced massive fallout in 2009. In these cases, winners have taken a more surgical and non-traditional approach to complement the traditional levers.

In summary, these actions are different from what was needed in the 2014/15 downcycle. The extent of uncertainty is greater in this cycle due to dual shock thus having a pulse on the situation dynamically is critical. Also, this cycle will force companies out of business so attempting to ride out the cycle is not an option. Cost actions need to be from a zero base, not current base. Portfolio actions need to be more structural, not adjustments that shift capital toward sweet spots. And while demand will be harder to create, topline impact can be mitigated through creative commercial arrangements. Finally, the capital markets have become intolerant so contingency planning has to be in place.

Rethink to emerge stronger

Companies will also need to go beyond traditional measures and take non-traditional pathways to rethink how they operate. Some of the current disruption trends were already in motion before the current supply and demand shock. Today's O&G players will need to fundamentally rethink and reduce their structural costs in non-traditional ways by:

1. Creating cost variability and eradicate complexity while freeing up capital particularly by leveraging support infrastructure

Evaluate and identify opportunities to shift cost and business/organizational complexity inherent in delivering or driving non-core technology, support functions and partner platforms. Focus the organization on the core business and maintain flexibility to dial up and down based on resulting market outcomes. This can mean having a partner take over functional support and technology delivery to drive both higher efficiency and service levels and manage cyclicality by consolidating activity from other companies. There are also relationships in which the service-providing partner essentially invests in the existing functional and technology infrastructure, taking it over (with an option to return it or sell it back), then providing service back to its partner at a considerably lower cost.

2. Joining hands with peers and competitors

Consolidate activity or assets through a formal or loose joint venture particularly in high-volume geographies like North America. This can be in the form of joint development programs particularly for contiguous upstream positions, sharing equipment and workforce, partnering on service agreements and other infrastructure while idling less favorable or sub-scale positions and assets.

3. Bringing the ecosystem creatively into play

Identify collaborative opportunities with operational and technology partners and/or service providers that require integrated planning and execution. Take a long view toward releasing trapped value that can benefit all partners while serving as an offset to direct price concessions. For example, between roughly 30% and 50% of inefficiencies sit where operators and oilfield services companies interface requiring collaboration. By partnering to realize gains, the operator can share the value or use the gains as an alternative to price cuts—the norm in such times. These actions need to go well beyond traditional collaboration. Looking again to the automotive industry as an example, when it faced a slowing market, Toyota sent sidelined engineers to supplier plants to help with cost management issues on subsystem production.

Challenging times call for smart measures—both traditional and non-traditional.

While the industry has dug itself out of many shocks and proven naysayers wrong in the past (think peak oil that preceded the 2014 supply renaissance and disruption), it is now faced with concurrent disruption at an existential, system-wide and player level—risks that will truly test its tenacity and durability. And while it may force a number of players to fold, those that will emerge will certainly be leaner and stronger.

About Accenture

Accenture is a leading global professional services company, providing a broad range of services and solutions in strategy, consulting, digital, technology and operations. Combining unmatched experience and specialized skills across more than 40 industries and all business functions—underpinned by the world's largest delivery network—Accenture works at the intersection of business and technology to help clients improve their performance and create sustainable value for their stakeholders. With 505,000 people serving clients in more than 120 countries, Accenture drives innovation to improve the way the world works and lives. Visit us at **www.accenture.com**.