The one-two punch for oil markets

A 2020 THRIVE GUIDE FOR DOWNSTREAM
Today’s oil and gas downstream market is experiencing unprecedented upheaval. Oversupply, low prices and a crippling public health pandemic have created an overwhelmingly challenging environment. Industry leaders have responded by focusing on operational continuity, health, safety and environment and cash preservation. What we do next will largely depend on crafting a thoughtful, agile playbook to confront the most pressing of these issues in order to turn this crisis into an opportunity. Traditional playbooks simply won’t suffice for navigating the current situation and thriving in the future.

The industry has faced daunting markets before, usually the result of sudden crude oil supply pullbacks in reaction to geopolitical unrest or an economic recession. On average, the severe impact of these market-tightening shocks lasted anywhere between one and six months.

Recent events, however, are shaking out as perhaps the most disruptive market in the history of the industry. On the demand side, a large portion of air travel has halted and the contraction of other modes of transportation has been significantly reduced. On the supply side, OPEC+ failed to reach a production curtailment agreement when Saudi Arabia announced it would flood the oil market. Eventually, the OPEC+ group agreed to a significant cut in production but oversupply still persists. Similarly, while refiners have cut production, there is still an oversupply of products.
While product prices have dropped and inventories have risen, the high level of uncertainty about the future that pervades the industry shows no signs of abating.

Typically, downstream players enjoy an initial margin windfall as crude prices drop faster than product prices. However, such windfalls tend to be short-lived. In fact, as economic activities grind to a halt, the demand effect drives overall refining margins—and perhaps retail margins—down. Deteriorating demand and profit margins for fuels produced at refineries—including aviation and motor fuels—are resulting into a reduction in operations. These reductions range from cutting refinery runs, to closing units, to completely shutting down refineries. The conflating factors at hand are increasing the pressure on refiners’ balance sheets, currently strained from a low-margin business environment.

The effects of demand destruction, among other factors, began emerging as early as the first quarter of 2020 (Figure 1):

Overall global product consumption for 2020 could be up to 10-20 million barrels a day lower in 2020 than in 2019:

- Flight numbers were down 70% at the start of April¹
- Gasoline was down by 50% to 60% in major global cities, and in the U.S., gasoline consumption was about 37% lower than the previous five-year average for late April²
- Refiners have already reduced the amount of crude they process by 7 million barrels a day, and are likely to halt as much as 25% of total capacity in May³

The one-two punch

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Figure 1: Demand destruction is significant

“Stay-at-Home” Peak Demand Destruction

It is all but impossible to predict when trends will reverse, but logically, such a reversal would require a number of factors to dramatically switch course—the crude supply and refinery runs would have to lower as demand rises. Essentially, the direct opposite of the situation leading to the one-two punch.

Some industry players are at high risk, with a median of 2.4 months of cash and cash breakeven refining margins uncomfortably close (Figure 2). Making matters more urgent, average U.S. and European refining margins have fallen between 35% and 90% from their Q4-19 levels.4

**Figure 2: Refining companies not immune to financial distress**

Financial position across regions has deteriorated

<table>
<thead>
<tr>
<th>Financial position across regions</th>
<th>Refining margins ($/bbl) are not enough for all players to break even</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Refining Margins</td>
</tr>
<tr>
<td>NA Refiner 2</td>
<td>$10.5 (High)</td>
</tr>
<tr>
<td>NA Refiner 3</td>
<td>$4.4 (High)</td>
</tr>
<tr>
<td>Global Refiner 1</td>
<td>$1.7 (Low)</td>
</tr>
<tr>
<td>Global Refiner 2</td>
<td>$0.6 (Low)</td>
</tr>
<tr>
<td>NA Refiner 1</td>
<td></td>
</tr>
<tr>
<td>Global Refiner 3</td>
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</tbody>
</table>

Source: Accenture analysis.

**Figure 3: Retail sector will also be hit hard**

Beyond the dire consequences the current situation is creating for cash generation and refining margins, other sectors of the oil and gas (O&G) downstream industry—such as fuels retailing—have experienced large margins, but that’s likely to revert the longer demand levels remain depressed (Figure 3).

Source: Accenture analysis.
Let’s be honest, not all downstream companies are likely to survive the current environment if it lasts for much more than a few months. In fact, the crisis is significant and novel for a number of reasons. Chief among them, demand can dip as much as 40% to 60% in some locations, triggering the need to reduce refinery runs and close down plants while critical employees and vendors may be unavailable. In addition, customers, vendors and employees are experiencing high stress levels, fearing for their health and the health of their family members.

None of the playbooks the industry has deployed in prior crises properly addresses all the challenges in today’s environment (Figure 4).

While these plans can serve as a useful starting point, particularly in terms of emergency response and early cost-cutting, leaders also need to:

- Prepare for more extreme operational scenarios with significant volatility
- Increase levels of optionality while cutting down costs
- Introduce hyper-localized action plans
- Reduce response times
- Provide emotional support to employees and other key stakeholders

**Thriving vs. surviving**

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**Figure 4: Old playbooks are not good enough**

<table>
<thead>
<tr>
<th>This is not the same as prior demand-supply imbalances</th>
<th>Tried and tested playbooks are only a good start</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. 40-60+% of demand drop in just days</td>
<td>A. Provide emotional support to employees</td>
</tr>
<tr>
<td>2. Hyper localization of supply-demand dislocations</td>
<td>B. Plan for extreme operational scenarios</td>
</tr>
<tr>
<td>3. Potential absence of critical employees and vendors</td>
<td>C. Have hyper-localized insights and action plans</td>
</tr>
<tr>
<td>4. Uncertain shape and duration of recovery</td>
<td>D. Cut costs and increase optionality at the same time</td>
</tr>
<tr>
<td>5. Unknown effect on long-term impact</td>
<td>E. Streamline response times</td>
</tr>
<tr>
<td>6. Lack of reliable long-lead indicators to plan around</td>
<td></td>
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<tr>
<td>7. Fear for the security and safety of self and family</td>
<td></td>
</tr>
</tbody>
</table>

Source: Accenture analysis.
While the industry has reacted by focusing on immediate continuity needs such as safety of operations, it must now address a number of critical issues, particularly around liquidity, resilience and going on the offensive, while transforming the way they lead and manage talent (Figure 5).

**Figure 5: Thrive guide for downstream**

**Virtual Command Center**
- Establish safe and effective ways to connect
- Define extreme scenarios
- Organize overall response

**Safe Operations**
- Assess readiness to extreme cases
- Revamp mobile workforce capabilities
- Protect against cyber attacks

**Liquidity**
- Delay non-safety-critical capex, cancel dividends/buy-backs, reduce working capital
- Minimize counterparty risk
- Strengthen balance sheet

**Talent and Leadership**
- Retain top talent
- Accelerate digital models
- Provide motivation and clarity
- Make trade offs clear

**Cost**
- Zero base your activities and spend
- Rethink sourcing
- Increase outsourcing

**Optionality**
- Increase refinery/manufacturing and operation flexibility
- Refresh contractual flexibility
- Rethink inventory levels and chartering

**Margins**
- Revamp demand forecasting, pricing and offering capabilities, leveraging advanced analytics
- Take production optimization processes and analytics to the next level
- Invest in value chain optimization and supply and trading tools and analytics
- Shorten planning cycles

**Customers and Products**
- Enhance product portfolio and redefine customer offers
- Identify collaborative opportunities with ecosystem partners

**Footprint**
- Re-envision what the winning footprint looks like, including new markets, the role of regional scale and vertical integration
- Acquire assets and/or companies to build desired portfolio
- Dispose what doesn’t fit

Source: Accenture analysis.
A closer look at today’s playbook reveals four critical components:

CONTINUITY

Practically all players have already taken steps to ensure operational continuity in light of needed refinery-run reductions. In fact, at the time of publication of this paper, there has not been any major incident. In addition, some leaders have already taken steps to ensure continuity in extreme cases of demand destruction and employee/vendor shortages. This includes preparing for a combination of run reductions, plant closures, high stock and inventory levels, and limited staff and vendor availability. Part of this effort has also included mapping out worst-case scenarios of demand destruction, customer and vendor distress, and labor and material shortages. Other actions we have begun to observe in the marketplace include revamping mobile workforce capabilities, re-imagining spatial work planning, stabilizing core systems to enable work-from-home, and reinforcing cybersecurity.

Where liquidity is concerned, leaders have taken early steps to preserve cash by:

- Delaying non-safety-critical CapEx
- Canceling dividends and stock buybacks
- Reducing working capital to minimize counter-party risk and strengthen the balance sheet

In addition, companies have been working to further release cash from working capital and manage collection risks by:

- Analyzing major receivables and payables to assess risk to working capital
- Renegotiating with suppliers to free up cash (e.g., lengthening payment terms)
- Monitoring customers to ensure days sales outstanding does not become overstretched
- Reducing inventory by freezing new purchases
- Using existing stock buildup
- Closely monitoring cash reserves

RESILIENCE

As companies begin to move from ensuring continuity to calculating next moves, putting measures in place to ensure resilience is critical. Essentially, leaders must prepare the organization for inevitable future product demand. We believe there are three chief components to resilience-building: reducing costs, enhancing optionality across the value chain and protecting and enhancing margins.

Reshaping downstream companies’ cost structure requires taking steps beyond making cuts to survive a potentially long period of low margins. Successful leaders will use this time to streamline their organization for the long run. It will likely be necessary to variabilize non-core costs and leverage digital tools to support safe and streamlined operations with minimum staffing.

Companies will need to look at lowering costs in a way that accomplishes two objectives. First, it must not compromise the ability to rebound quickly. Second, it should include measures such as outsourcing to increase resilience for future industry volatility.

Practical tools to significantly change the cost structure include:

- Zero-base the company’s spend, eliminating “non-working” expenditures
- Rethink operating model and organizational structure, including what, where and how work gets done
- Increase outsourcing of support functions and other work activities
Beyond costs, companies also need to maintain and increase optionality. This is particularly important given the hyper-localized nature of demand destruction. The uncertainty of demand recovery, including the potential irregularities within short timeframes also make maintaining and increasing optionality imperative. Industry leaders must look purposefully at the optionality they have in their operations and supply chains, including logistics, contractual flexibility and inventory levels.

Important optionality considerations include:
• Improving visibility of current operations and degrees of freedom
• Improving contractual flexibility across the supply chain, from sourcing to selling
• Re-assessing distribution network model, including optimal inventory levels, as well as approaches to chartering and storage

In addition to cost and optionality, companies will also have to enhance their capacity to capture margins under a broader set of situations. Key considerations include:
• Improving pricing capabilities
• Adjusting terms and service levels to customer profitability
• Shortening planning cycles to better react to changing market conditions

GO ON THE OFFENSIVE
Beyond ensuring continuity and resilience, O&G downstream companies must also consider how to emerge stronger after the crisis. This is the time to think about how to use this opportunity to position for leadership, which requires a deep consideration of factors such as customers and products as well as the company’s footprint.

Where customers and products are concerned, we recommend industry leaders consider how to enhance their companies’ product portfolio and redefine customer offers. The goal is to increase share of wallet aggressively for existing customers—while acquiring new customers.

Tangible actions include:
• Enhance offering and product portfolio to reflect current customer needs
• Selectively invest in growth and next-generation products aligned with energy transition
• Rethink marketing spend to support retention and growth targets

Companies should also explore what a winning footprint looks like, including new markets, the role of regional scale and vertical integration. Looking to reposition the portfolio strategically could mean acquiring assets and/or building a footprint by seeking opportunities to:
• Strengthen regional leadership positions
• Expand into adjacent markets
• Secure advantageous sources of crude and lock in access to attractive markets

At the same time, companies should consider shedding what does not fit and determining the right approach and timing for discarding marginal assets. They may also consider exploring consolidating activities or assets through formal or loose joint ventures, particularly in high-volume geographies such as North America and Europe.
TALENT AND LEADERSHIP

Leaders should focus on building and maintaining trust and confidence with their workforce and other stakeholders. Our research found that over 64% of the global workforce is facing high anxiety over their personal job security.5 This anxiety is further compounded as work may open, but schools and elderly care may not—in fact, 67% of American children under six have all available parents participating in the workforce.6 In light of the volatility in downstream markets, compounded by these human stressors, downstream leaders need to do three things well consistently for their people: Communicate with compassion and confidence, build trust through the company’s purpose, and care about employees’ work problems and their households.

Actions to retain (and build) talent include:

• As roles are disrupted, focus on skills not jobs
• Turn furloughed workers into flexible workers, retraining them in skills that will enable them to refocus on areas of higher demand
• Build AI-based processes to help predict skills demand in immediate and adjacent markets; for example, in an international oil company, assess how the linear programming skills of a refinery engineer can drive end-to-end value chain optimization from the wellhead to the pump
• Connect workers with job opportunities at scale, either internally or externally, using technology platforms; for example, supply chain and logistics skills which are core to downstream, are much needed outside oil and gas by e-commerce players
• Accelerate learning by curating updated program choices and maximizing adoption with AI-enabled personalized learning
• Support people with career pathway advice and career planning
• Support people by leveraging the many technology platforms that help match workers with safe childcare options during the crisis

Practical actions leadership can take to inspire trust and confidence:

• Address your people’s mental, physical and relational needs. Examples include offering life coaches, mental health support and wellbeing programs to help grieving employees or those managing stress, such as those caring for elderly patients and partners of key workers
• Honor losses and ensure leaders share their own COVID-19 experiences
• Elevate consciously compassionate leaders to lead the charge and position them to coach others in empathy and communications skills
• Give greater prominence to the organization’s purpose and values, particularly its commitments to its people
• Communicate early, often and with compassion
The long view

While the long-term effects of the one-two punch on the downstream market are unknown, it is still important to have a view of the mid- and long-term future while taking a proactive stance. It is fair to expect that the one-two punch will accelerate the pace of already-existing trends such as shifts in demand patterns, the move to customer-centric models and the decarbonization of the energy ecosystem.

The shakeout of these trends will vary greatly depending on timing, location and other factors. For example, a refinery in Western Europe will see a very different reaction than a retail operation in Southeast Asia. Similarly, it is likely that the destruction of the demand for hydrocarbon-based transportation fuels will look very different in the U.S. in 2030 than it will in Latin America, where it will likely still be growing. Understanding the nuances of these trends will influence whether the decisions in the next weeks and months will have been correct or not.

In challenging times, it is not uncommon for companies—entire industries, in fact—to become so caught up in devising ways to address a crisis they miss opportunities. Searching endlessly to find a perfect solution is not an option. Instead, this is the time to act swiftly and flexibly.

Executives need a flexible and holistic playbook in order to navigate the months ahead of the one-two punch and to devise strategies that will take them from the now to the next.
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