Oil & Gas Solutions

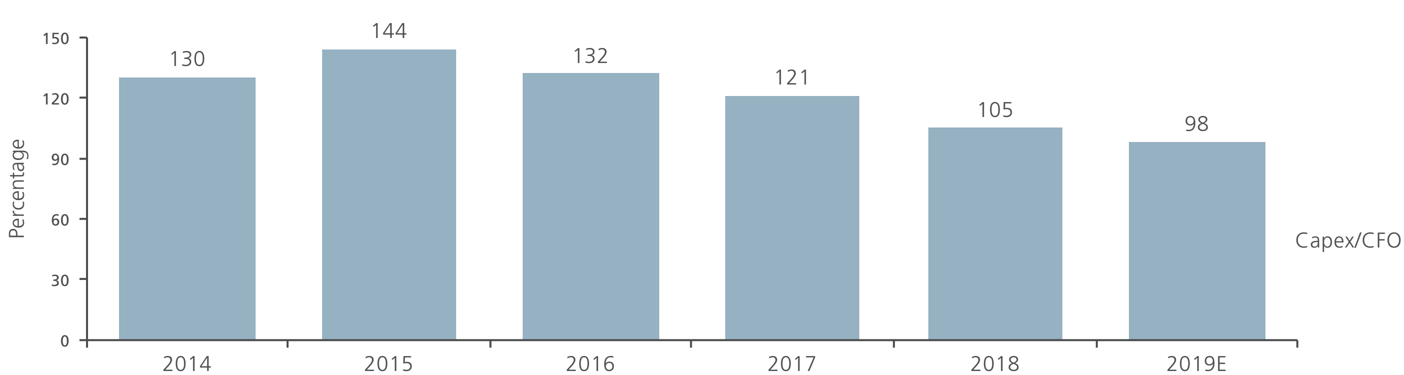
Applying L.E.K.'s Quick & Integrated Cost-out Tool to the Oil and Gas Sector

Balancing capital and free cash flow remains the key philosophy for exploration and production (E&P) and oilfield service companies operating today. Public equity capital flows into the sector are at their lowest level since the early 2000s, and debt capital is equally out of favor, which means self-funding is the only way to fuel growth and, for some, the only means of survival. Critical, of course, is the prudent allocation of capital by evaluating which plays to target or what equipment to rebuild versus retire. Just as important is improving the productivity of assets by optimizing well and field designs and equipping the labor force with digital tools to improve real-time decision-making. But achieving best-in-class returns for shareholders requires more, and often that involves the notoriously difficult task of significant and sustainable cost reduction.

While the blueprint for a cost-reduction plan is unique to the company and sector, E&P and oilfield service companies are identifying similar levers. First, general and administrative (G&A) expenses revolving around support staff and discretionary spending are targeted. Second, there is a call down the supply chain to lower costs. E&Ps have relentlessly negotiated pricing with their service and equipment providers, that in turn are squeezing their assembler, manufacturer and fabrication partners to reduce their own costs and lower prices. Third, companies are optimizing their asset or product portfolios. E&Ps are positioning assets, both organically and through M&A and asset deals, to achieve local scale and spread out fixed costs. Oilfield service companies are reducing exposure to unprofitable business lines, often in the most fragmented oilfield service land segments. Both parties are also integrating data science techniques to drive cost reduction through efficiency gains.

Establishing cost improvement programs and achieving sustainable targets take a significant corporate-wide effort. However, L.E.K.'s Quick & Integrated Cost-out approaches this initiative in a broad and parallel campaign, in which program

Figure 1
Public E&P cash flow from operations (CFO) vs. capital expenditures (Capex) (%)



Note: Includes APA, XEC, CXO, CLR, DVN, EOG, FANG, HES, MRO, NBL, OXY, PXD, BRY, CDEV, CPE, LPI, MUR, OAS, PE, QEP, WLL, WPX, COG, CHK, GPOR, RRC, SWN
Source: Simmons Energy

activities and resulting savings are accelerated for the business, leading to faster realization of sustainable free cash flow.

Challenges facing our clients today

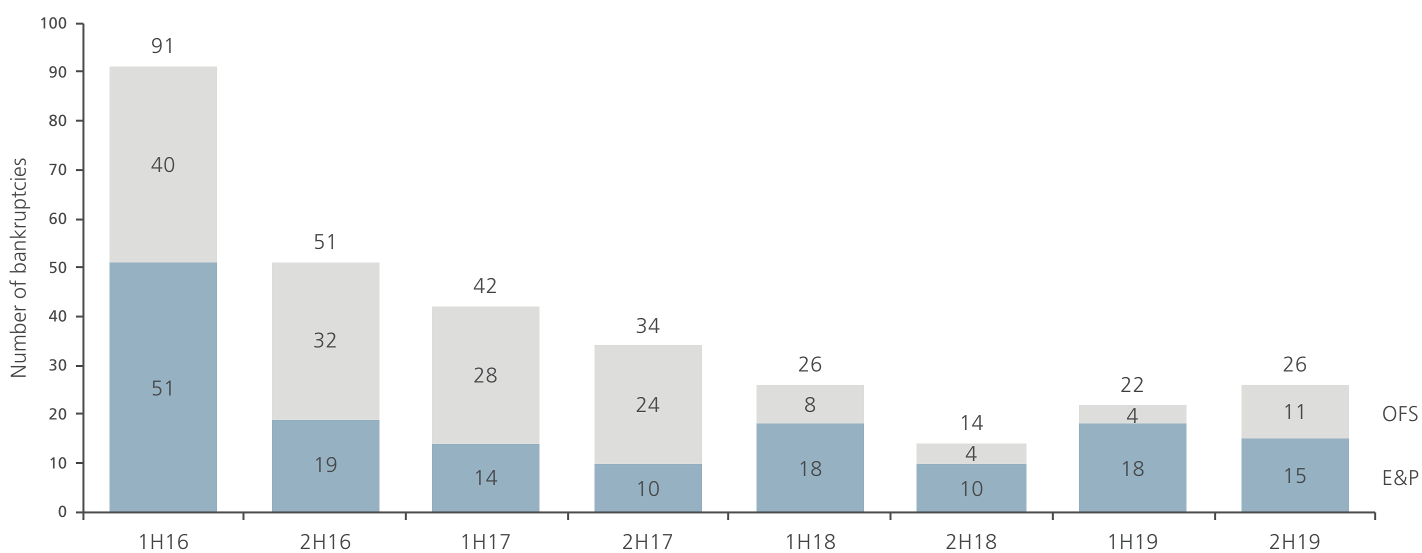
While complex externalities weigh heavily on energy commodity markets — the U.S. elections, the U.S.-China trade war, a slowing global economy, heightening geopolitical tension, implications for Saudi's strategy following the Aramco listing — the biggest challenge for the U.S. oil and gas sector may still be whether the E&P model works for, as according to Rystad Energy, the approximately three-quarters of U.S. land players that are still failing to reach CFO to Capex neutrality and sustained profitability.

The market is moving in the right direction. E&P capital discipline is improving, and we have seen cash flow to capital balances among large public E&Ps move from 140% outspend in 2015 to near balanced spending today (see Figure 1). E&Ps, which are discipline is limited to the best-in-class public E&Ps, which are driving down lifting and G&A costs through large-scale cost-out programs or merger and acquisition (M&A)-driven synergies.

Unfortunately, material improvements have been limited to a subset of leading E&Ps. Approximately half of the rig count is operated by privates or the smaller end of the public midmarket E&P universe that remains challenged by cost control. For the oilfield service group, it is much the same. E&P margin improvements do not necessarily pass through to the oilfield service sector, and market feedback in a recent note from Simmons Energy suggested any increase in 2020 commodity prices captured by E&Ps is likely to transfer through to shareholders or be used to pay down debt, not to provide pricing or activity gains for oilfield services. Intensifying the situation is the $200 billion-plus of debt maturing through 2024. We are beginning to see the impact of the debt burden as oilfield bankruptcies are trending again according to data from Haynes & Boone (see Figure 2).

To avoid the extended pain and a potential new wave of restructuring, we submit that in the absence of sectorwide consolidation on both the E&P and oilfield service fronts, the sector's efforts must turn to sustainable cost reduction — an effort that should be executed efficiently while allowing leadership to focus on commercial orientation in what is a quickly evolving marketplace.

Figure 2
Oil and gas bankruptcy trend (count)



Source: Haynes & Boone LLP

The L.E.K. approach to sustainable cost reduction

L.E.K.'s Quick & Integrated Cost-out (QIC) is a rapid and broad performance improvement campaign that diagnoses, mobilizes and delivers in parallel, rather than moving slowly through a sequential process.

QIC is founded on an integrated process of:

- **Costing the full potential** — doing just enough to discover the opportunities and set targets
- **Business-led planning** — engaging early with the organization and supporting initiative ownerships to define specific actions required
- **Delivering the plan** — progressively achieving the results

A QIC program could act as the accelerator that midmarket oil and gas companies need to make rapid and agile performance improvements to meet short-term challenges and achieve longer-term fitness in today's relentless focus on building a sustainable free cash flow business (see Figure 3).

Achieving free cash flow full potential

E&Ps and oilfield service companies need to pursue three priorities in parallel with cost reductions in order to meet their short- and long-term free cash flow and capital balance goals:

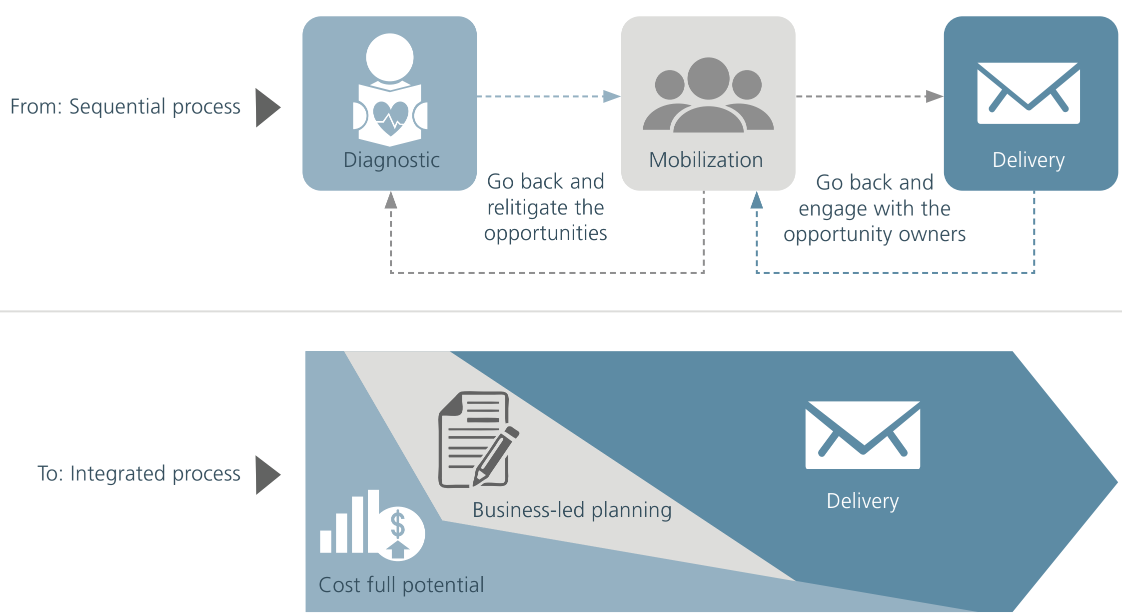
1. Deploy capital prudently

To weather the potential challenges of 2020, oil and gas companies should manage their capital wisely in order to meet challenges over the next year, including appropriate capacity reductions in lieu of maintenance spending and cancellations/deferrals in non-mission-critical capital spending.

2. Optimize the business portfolios for growth

Beyond strengthening their short-term position, both E&Ps and oilfield service companies must focus on ensuring their portfolio activities are value-generative and internally consistent. To this end, they should A) seek to optimize their portfolio of assets and geographies, focusing their efforts on areas of maximum strength and profitability; B) identify tactical M&A that can materially improve their customer offering or cost position (given the fragmented nature of the market); and C) build operational

Figure 3
L.E.K.'s Quick & Integrated Cost-out



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Case study: How QIC works in practice

L.E.K. recently supported a well construction and maintenance services provider supporting E&P operators. One of the client's E&P customers was struggling with its own cost position and viewed their agreement as a potential lever for cost savings, putting the profitability of the contract under pressure. Specifically, there was pressure for short-term improvements to ensure our client:

- Was cost competitive with alternative providers
- Was considered a candidate for contract renegotiation
- Returned the contract margins to acceptable levels

The QIC approach started with a rapid eight-day diagnostic, identifying contractwide deficiencies across core management processes and personnel capability and targeting a 20% value improvement potential from enhancing cost driver performance.

Following the diagnostic, a 12-month transformation program was formed with a joint client/consultant program team to build required capability and drive rapid progression of the change program. The first three months of intervention focused on delivering short-term profitability gains, improving E&P operator pain points and laying the foundations for sustainable performance in the long term. The delivery model directly engaged with those impacted by the change throughout the solution design and execution.

Through the QIC, our client achieved a significant improvement in contract margin and productivity performance, including:

- 20% improvement in productive work time
- 25% overhead reduction
- 15%-20% unit cost reduction
- 40% improvement in estimation turnaround time

Improvements demonstrated the client's commitment to its customer and led to a successful contract renegotiation with the E&P operator. The client also retained the contract improvement IP and developed a "playbook" that was rolled out for other major contract interventions.

agility, allowing for greater flexibility in capital intensity in order to sustain cycle challenges.

3. Develop and integrate an advanced data science capability

The market needs to find ways to generate value through advanced data and analytics by deploying these tools in a targeted and thoughtful manner. Companies should utilize best practice approaches such as the ones L.E.K. has identified for advanced analytics, focusing on rapidly defining and addressing the right problem, ensuring the "right data" exists and gathering it, assembling the "right expertise," and ensuring the right organizational configuration.

Contact

Applying L.E.K.'s Quick & Integrated Cost-out Tool to the Oil and Gas Sector was produced by **Nilesh Dayal** and **Simon Horan**, Managing Directors; **Amar Gujral**, Principal; and **David Raffa**, Senior Manager, in L.E.K. Consulting's Oil & Gas and O&P practices. For more information, contact oilandgas@lek.com.