Executive Insights

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Survival of the Fittest: How to Thrive in a World of Low Oil Prices

It may not feel like it, but amid the continuing slump in the price of oil, companies servicing the oil and gas industry have a golden opportunity to enhance their competitive position and maximize their advantage when the price recovery occurs.

We estimate that there is an 18-month window for companies to put in place the measures needed to reshape their businesses and prepare for growth. But the time to act is now — because when the cycle turns, it will be too late.

To address both the challenges and the opportunities of a world in which lower oil prices are the norm, L.E.K. Consulting has developed a three-part strategy to help companies survive the slump, improve their performance and prosper in the future.

Figure 1
Factors influencing the future oil prices

	OPEC production	Iran production	U.S. shale	Demand scenarios
High oil price case	• OPEC agrees to cut production; other non-OPEC countries (Russia) do the same • Low output in countries with troubled economies	• Iran begins exporting less than 500kb/d due to capacity and infrastructure constraints	• Production continues to tail off due to reduction in new wells and economic constraints of independent producers	• China and U.S. gasoline demand continues to increase • European economy growth increases demand
Low oil price case	• OPEC and other non-OPEC countries continue to produce • Long-term focus on market share protection	• Iran boosts production by 500 kb/d, increasing to 4 mb/d in early 2017	• Frac count remains high and further well productivity gains are obtained • Production levels stabilze as lower rig count is offset by higher fracking activity	• China growth constrained by lower GDP growth • U.S. gasoline demand stabilizes • European economy continues to underperform

Source: L.E.K. analysis

Survival of the Fittest: How to Thrive in a World of Low Oil Prices was written by **Peter Debenham** and **Jeremy Wheatland**, partners in L.E.K. Consulting's Industrial practice. Peter and Jeremy are based in London.

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The context for change: Today's slump and when the cycle turnss

The downturn in the oil price has been influenced by a number of well-documented supply, demand and geo-political factors. With so many variables, there is no consensus on the short-term forecast for when the oil price will demonstrate a prolonged and sustainable rise (see Figure 1).

As this uncertain environment develops, oil and gas service companies and equipment providers need to consider four likely outcomes:

1. When the oil price does recover, it will be a further 12-18 months before they can expect to see the benefits, because producers will initially retain much of the the price increase benefits for their own financial recovery and investment in exploration activity.
2. Unlike previous recoveries, when the oil price rises, it is likely to plateau at lower than historical levels, because the relatively flexible and innovative U.S. shale producers will be able to boost their output in short time frames as the economics improve. This will increase competition among oil producers and dampen the price rise.
3. The shape of the oil industry will almost certainly look different after such a sustained slump. In 2015, oil companies deferred 68 capital expenditure projects worth around $380bn.[1] Some 30 deepwater projects were postponed. If the oil price plateaus below $80, as it is expected to do, it may be that some of these more complex projects will never be revived. The North Sea industry, in particular, could be affected in a significant way because of its high cost of operation.
4. The supply chain continues to be highly deflationary and will need to consolidate and adapt to the new normal of "lower for longer." Maintenance periods, for example, are being extended significantly to reduce operating costs, and higher activity levels may never come back to where they were before the slump if the current maintenance periods prove sustainable.

Survive at low oil prices

Before companies can look to the future, they need to survive, and the number one action for survival is cost reduction. Of course, most, if not all, companies have been doing this — but the enduring nature of the slump means that multiple rounds of cost-cutting are likely to be necessary. Prudent companies will be reshaping their businesses so that they can continue to operate profitably when the oil price is at $40-$50 per barrel.

The cost reduction starting point for most companies is staff, and we have observed a number of companies having to reduce both frontline staff and also overheads, which need to be rightsized for the current environment. For example, BP announced in January 2016 that it will axe 20% of North Sea jobs as it cuts 4,000 staff worldwide.

However, an even more difficult round of cost reduction is likely to be required. Cutting deeper brings risk and requires a thorough capability analysis if critical skills are to be retained for the future.

Figure 2
Workforce capability sustainment strategy

	Define	Size	Sustain	Deliver
Issues to consider	• What capability do we need to sustain?	• How many staff are required in a "sustainable core" from which we can re-grow?	• What options are available to sustain the capability?	• How can this be delivered in practice?
Supporting work	• Establish an output-oriented "Domain" framework to describe capability • Define capability with input from Subject Matter Experts • Articulate the competitive advantage delivered by this capability	• Generate a robust view of the minimum staffing level for individual domains • Challenge, review and iterate process	• Identify the demand for each domain from current and future projects • Assess gap between forecast demand and the 'sustainable core' • Identify and prioritize other potential opportunities to close the "gap"	• Supply / demand scenario stress testing • Evaluate the organization against different demand scenarios • Generate actionable recommendations, such as -Changes to internal structure and delivery models -Improvements in HR agility -Alignment of sales and resource planning

Source: L.E.K. analysis

A structured approach enables the right decisions to be made by helping organizations to understand what their most important capabilities are, the scale they need to retain, how to retain that scale and how this can be delivered in practice (see Figure 2).

In the first instance, two fundamental questions should be addressed:

- What is the core capability that provides our competitive advantage?
- What capabilities do we need to retain to exploit the recovery?

Armed with the answers, companies should build scenarios, assessing what capabilities are required at different points in the recovery cycle. Having done this, they should find ways to retain the staff who possess vital skills. This might require the introduction of flexible contracts or the transfer of the most valuable staff to other parts of the company until business recovers.

Improve performance: Salesforce effectiveness, supply chain efficiency and operations optimization

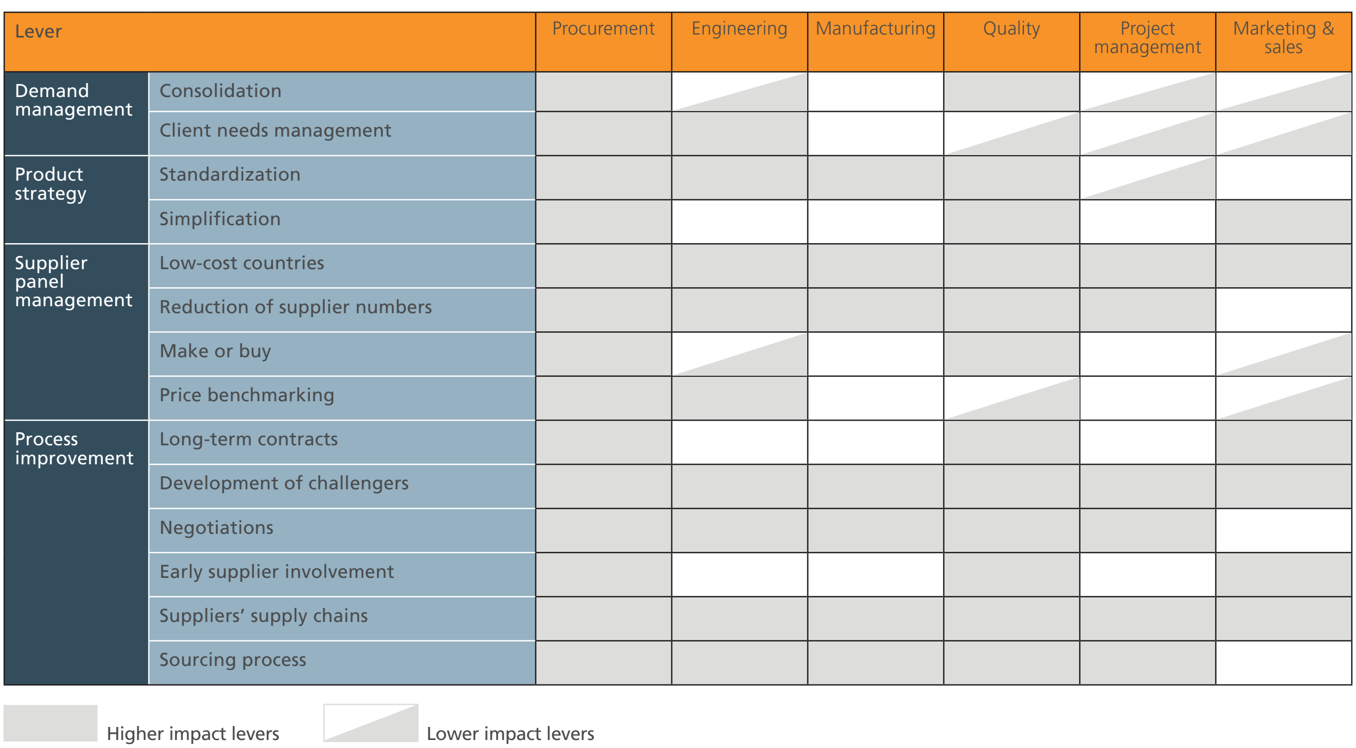
Having addressed their cost base, companies should introduce targeted operational performance improvement programs. This will ensure that the business can operate in a lower-revenue environment, win market share and deliver the healthy profitability needed as both a protection against predators and an asset for pursuing growth through M&A.

To effect better performance, there are three key areas on which to focus:

1. Salesforce effectiveness. It is essential to understand the nature of the customer decision-making process. Who are the decision-makers and who are the influencers? Increasingly, producers are centralizing global procurement contracts and yet the final purchase decision can still often be made at a local or regional level. What are their key purchasing criteria and how can you best differentiate yourself against other suppliers? In order to truly understand how to win, it is necessary to conduct a robust data-mapping exercise. The salesforce then needs to be organized to align with different customer segments, then clear targets, training, incentives and tracking metrics need to be developed to ensure profitable, market-leading performance.

2. Supply chain efficiency. Over the past five to 10 years, industry costs have spiraled as operators have demanded bespoke solutions for exploring in hostile environments and also for seeking to maximize field efficiencies. But, in an age of low oil prices, there needs to be some cost-benefit analysis to develop affordable, more standardized solutions, with service companies, operators and equipment suppliers working together to optimize the design and specification of equipment and parts. AkerSolutions attributes 35% of its cost-cutting to the development of more standardized

Figure 3
Cross-functional improvement levers of an enhanced sourcing strategy



Source: L.E.K. analysis

solutions, and Amec FosterWheeler launched its "More4less" campaign with Maersk, resulting in 30%-60% project savings.

Consolidating spend and building stronger relationships with the right suppliers are both required to ensure costs and service levels are best in class. It is critical to engage all relevant functions that impact materials sourcing in order to optimize bottom line performance (see Figure 3). We have seen up to 30% supply chain savings achieved through product re-engineering, enhanced procurement strategies and organizational changes.

3. Operations optimization. In the era of high oil prices, operational efficiency, although important, was never the key priority. Now, there is an opportunity (necessity) to streamline the business and put it on a more sustainable footing. To do this, companies should increase their understanding of the operational key performance indicators for their businesses. Optimizing engineering capability is frequently a key value driver and approaches to achieving this are frequently misunderstood. There is no standard set of KPIs: each company will need to work out which ones are the most important for them. Once defined, these KPIs should be used to refocus the business and, ultimately, to maximize value and cash flow.

While companies may be moving in these directions, many are still not acting fast enough to ensure they are in the best shape to win in what will remain a highly competitive marketplace for the foreseeable future. Highly effective program management capabilities are also required to deliver the benefits identified.

Prosper in the future by reconfiguring the business model

The oil industry will be reshaped by the prolonged slump, with the highly fragmented supply chain consolidating as the weak fade and bankers and shareholders choose not to support the laggards. Oil service companies and equipment providers therefore need to take this opportunity to reconfigure their business model so that they are positioned to prosper in the new environment. Strategic partnerships, joint ventures, and mergers and acquisitions will all prove useful tools on this journey. Examples include Technip, which has developed a JV (Forsys) with FMC to drive technology innovations in subsea projects; and Fluor, which has acquired Stork to provide more integrated customer solutions. Indeed, there are many service companies pursuing an "integrated system" strategy, some with more success than others.

Traditionally, the relationship between the operators and the supplier base has been transactional, with a defined service undertaken for a fee. But leading service companies and equipment suppliers will forge new and more expansive partnerships with oil companies. Together, they could develop integrated solutions for optimizing the efficiency of the supply chain by, among other things, sharing assets or avoiding the duplication of activities, or reducing the burden of monitoring supplier performance. As part of this, service companies could propose a risk-sharing arrangement where they provide some services for a share of the profits rather than a fee.

Why the time to act is now

The oil price will recover to higher levels, and when it does, the best-placed companies will be those that have used the window of opportunity to enhance their competitive position. Scale, agility, innovation and speed to market will all be increasingly important as the industry is reshaped and efficiency becomes the key determinant of a winning strategy.

Clearly, the first job is to survive. But, in our view, winning competitors should do far more than this — to improve and prosper by rebasing their operational performance and reconfiguring their business model. If they do this, they will become leaner, fitter and better adapted to the new post-slump environment — and they will be in a prime position to exploit the recovery and take market share.

About the Authors

Peter Debenham is the Global Co-Head of L.E.K. Consulting's Industrials practice. He has been with L.E.K. since 1996 and is a member of L.E.K.'s European Regional Management Committee. Peter has over 20 years of experience assisting corporate clients in developing distinctive strategies and improving their bottom-line performance. He also has significant experience in mergers and acquisitions, due diligence, and post-acquisition support.

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About L.E.K. Consulting

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and rigorous analysis to help business leaders achieve practical results with real impact. We are uncompromising in our approach to helping clients consistently make better decisions, deliver improved business performance and create greater shareholder returns. The firm advises and supports global companies that are leaders in their industries — including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. Founded more than 30 years ago, L.E.K. employs more than 1,200 professionals across the Americas, Asia-Pacific and Europe. For more information, go to www.lek.com.