THOUGHT LEADERSHIP

HAVE U.S. E&P COMPANIES REALLY ADAPTED TO THE NEW OIL PRICE ENVIRONMENT?

OIL PRODUCERS THAT HAVEN'T MADE MORE PERMANENT AND STRUCTURAL COST REDUCTIONS WILL SEE THEIR BREAK-EVEN COSTS RISE AND RATES OF RETURN SHRINK WHEN OIL PRICES RISE.

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Dennis Ulak, a Business Advisory senior director specializing in the oil and gas industry (O&G), and Mitch Polelle, an associate within Enterprise Solutions & Analytics, share their thoughts on the O&G environment and what energy and production (E&P) companies can do to ensure sustainable cost structures when oil prices bounce back.

After hitting a low of $27 a barrel in January 2016, oil prices have been hovering at or just above $50 per barrel for several months. At the same time, the U.S. drilling rig count has steadily increased over the same period, leading some to speculate that U.S. shale producers have "won the battle with OPEC" and that they have adapted to the new price range of approximately $50 per barrel. Do you agree with that view?

Dennis Ulak: Generally, I would say no. Most producers do not have much, or in some cases, any acreage that has drillable prospects at $50 per barrel. Most producers have not made structural cost reductions and instead are operating in an oilfield service environment where the cost of goods and services are unsustainably low.

Can you explain what you mean by "drillable prospect?"

Dennis Ulak: Sure. Drillable prospect is when the producer has identified a drilling location on leases that it owns that will yield an acceptable rate of return after accounting for the cost of the leases, drilling and completion, allocated general & administrative (G&A) expenses, field operating expenses or lease operating expenses (LOE) and the producer's all-in cost of capital. Many "break-even" charts only include the drilling and LOE costs and this can be very misleading as to a company's position. It is an important metric for all parties to understand.

Tell me more about the oilfield service environment and why it is not sustainable.

Dennis Ulak: There are low barriers to entry in the oilfield services and the expansion that occurred in the boom part of the cycle—from 2011 to 2014—brought in a multitude of new entrants in all aspects of the oilfield service segment. When the price of oil started to collapse in 2014, many of those producers went bankrupt or went out of business without filing bankruptcy. The remaining oilfield service providers have lost pricing power and have no capacity to set their prices at an acceptable rate to achieve a margin. However, for the time being, their balance sheets permit them to stay in business at breakeven or slightly less than breakeven, allowing them to maintain use of equipment and the capacity to employ employees. When the suppliers' pricing power returns, the oil producers that haven't made more permanent and structural cost reductions will see their break-even costs rise and rates of return shrink.

How do you explain the increase in rig counts and producers talking about reasonable rates of return at $50 per barrel or even as low as $40 per barrel?

Dennis Ulak: The "best of class" producers frequently own the best acreage—the rocks with the best productivity. They also have improved drilling and completion techniques for more oil per dollar spent, which is done both through internal trial and error and by observing best practices of competitors. They've cut costs structurally by eliminating inefficiencies in field operations, optimizing the supply chain, improving procurement practices, and reducing overhead or G&A expenses. Taken together, these improvements are resulting in some producers having drillable prospects at $50 per barrel and even at $40 per barrel.

If you're an oil producer and you know your cost structure is unsustainable, how do you go about making the changes needed to stay in business?

Dennis Ulak: Oil producers should start by evaluating the entirety of their operation on a clean slate or bottoms-up and top-down basis. This means evaluating and removing all unproductive operational steps and then revising the operation and planning model. Producers should work with suppliers to get their input on efficiency and to find joint ways to cut costs and then gain share the advantages of the revised plan.

Reconfiguring the cost structure requires time, so if you are a producer that is operating month-to-month or in extreme distress, it will be very difficult to implement. Typically, suppliers require a one- to two-year commitment in exchange for lowering their costs below current market.

Some economists theorize that volatility in oil prices is the new norm, thereby making it difficult for O&G companies to plan financially. How can oil producers plan or know where to cut costs in an unpredictable environment?

Mitch Polelle: The best method for mitigating this unpredictability is by using dynamic models that can quickly and accurately respond to changes in baseline assumptions, as well as preemptively model multiple scenarios around these assumptions to better plan for the future. Companies should understand how they will respond to adverse scenarios before they occur. While of course every company is unique, there are common outputs that should be communicated to investors, lenders and governmental agencies. At a minimum, companies should be able to forecast earnings per share, cash flow, credit ratings and financial ratios for distribution and planning purposes. Since bottom-line company financials are inevitably influenced by strategic decisions, the underlying goal of a dynamic model should be to provide insight on how to positively influence these metrics given various scenarios.

What are some strategic decisions a company may want to analyze?

Mitch Polelle: Two common use cases are well development and M&A activity. Since well development is a major capital cost for O&G companies, it is important to have a firm grasp on how different oil prices impact the profitability of wells in the future by running base-, best- and worst-case scenarios. Companies can analyze the strength of their balance sheets in each case to understand if the return outweighs the risk. Additionally, since deteriorating balance sheets provide an opportunity for strong companies to acquire weaker competitors, a low price environment allows a strong company to make

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a strategic play that more broadly strengthens its underlying business. Financial departments and corporate development teams must be able to quickly analyze the effects that a possible acquisition has on key metrics.

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