A new energy world

Why costs matter in an era of resource abundance

Canadian energy survey
After more than three years of US$100 per barrel, oil prices collapsed by nearly 50% in late 2014. The precipitous drop was a result of a supply-demand imbalance, brought on by a combination of factors, including OPEC’s (mostly Saudi Arabia’s) decision to maintain production levels, modest oil demand growth since 2010, restored production in countries like Libya and Iraq, and the significant increase of light tight oil production in the US.

The oil and gas sector has experienced periods of uncertainty before, but this time is different. The industry is undergoing a structural shift, from an era when businesses were built around a “resource scarcity” model to a new era where businesses will have to thrive in the face of “resource abundance.”

In a resource abundance world, future commodity prices will not preserve or rescue high-cost projects or unconventional plays with higher operating costs. Capital-intensive unconventional resource development, increasing regulatory and environmental costs and the growing technology and service costs of unlocking abundant yet complex plays will drive new business models and a renewed focus on operational excellence and innovation. The likely result will be a bifurcation of winners and losers – those able to adapt and those who fail to adjust.

To succeed, companies must take a more strategic, longer-term view of cost management. It’s not just about surviving – it’s about thriving. Simply put, companies that are waiting and wishing for oil price recovery while only making short-term and tactical cost reductions during this period of uncertainty may be the real losers.

To thrive in this new era, companies must seize opportunities to develop strategies that produce real value and sustainable cost management over the long term.
Energy cost management survey

In late February 2015, we conducted a survey of leaders across the Canadian energy industry – including service companies – to understand how organizations are responding to the current economic environment.

Macro-economic impact

A total of 95% of respondents, both large and small, viewed the decline in oil prices as having a medium or high impact on the current economic environment, indicating that the decline is being broadly felt in the energy sector and in the Canadian economy as a whole.

Do you think that a sustained drop in oil prices will have a positive or negative impact on the Canadian economy more broadly?

Impact by size

Impact by sector

About the survey

EY surveyed a carefully constructed, representative sample of more than 130 senior executives in a range of Canadian energy-related organizations. Respondents represented all aspects of the industry value chain, including fully integrated oil and gas; upstream oil and gas; pipeline/midstream; oilfield services; power and utility; and engineering, procurement and construction (EPC) companies. The sample included representation of companies of all sizes, from fewer than 100 employees to more than 5,000.
Organizational responses

Significantly, 92% of respondents reported having either minimal or no long-term strategic cost management strategies in place in response to the economic conditions. While organizations have been swift to react with immediate and blunt short-term tactical changes, they either have not taken a longer-term view of structural changes or are still in the process of understanding what changes may be required.

Looking at major industry projects over the next 12 months, the survey results suggest that conventional oil and gas projects will take the largest hit in the coming months, with 78% of respondents identifying current economic conditions as having a high or very high impact. Of respondents surveyed, 69% also see the current economic environment having a high or very high impact on oil sands projects. Midstream and pipeline projects will feel some impact, though far less than their upstream business partners will feel, due partly to the contractual nature of pipeline and midstream projects.

Impacts on major industry projects

Oil sands and conventional oil and gas projects are being directly affected by the economic environment, while the impact on growth prospects for those in the mid-stream will be delayed.

What impact do you see the current economic environment having on major industry projects for conventional, oil sands, pipelines and LNG over the next 12 months?
How are organizations responding to a lower oil-price environment?

While cost management is on everyone’s radar, the primary levers companies are pulling seem to be expense management, capital allocation and headcount reductions. Not surprisingly, companies are looking to use refinements to capital allocation processes to prioritize high-return projects while delaying or canceling lower-return initiatives to preserve cash. At the same time, while headcount reduction is an option for many organizations, those with fewer than 100 employees are instead looking for process optimization, in large part because they can’t afford to lose what few resources they have.

Companies with strong balance sheets in segments feeling the greatest impact – such as integrated oil and gas and some larger oilfield services companies – are considering using collapsing oil prices as an opportunity to acquire good assets from weaker rivals to support longer-term growth objectives.

Meanwhile, oilfield services and upstream oil and gas companies are most interested in changes to their workforce strategies, with more than 50% of oilfield services respondents indicating that they are actively pursuing changes now. This is not surprising given the intense pressures they are feeling from the exploration and production (E&P) companies to reduce the costs of their services. Only a select few companies (those with more than 5,000 employees or that are fully integrated) with the size and scale to get a return on their investment are considering global solutions to cost management, such as outsourcing and strategic sourcing strategies.

Challenges organizations are facing with their cost management approach

The capacity to run their business with fewer resources isn’t limited to smaller energy players. In fact, all but the largest demographic identify the ability to run the business while reducing cost and allocating work across a smaller workforce as a key challenge.

Prioritizing, implementing and executing opportunities also pose challenges for companies across the industry – an issue that is highlighted by the fact that revising the capital allocation process is one of the primary levers organizations are pulling.

What are the top levers you are pulling in response to the changes in the economic environment?

What is the primary challenge your organization is having with its approach to cost management?
Where the greatest functional impact lies

While capital and major projects are feeling the most pressure, our survey results indicate that the pain of the economic downturn is being felt across entire organizations. Importantly, however, no respondents indicated impacts to the health, safety and environment of their organization, reinforcing the importance of safety in operations as a core priority.

Which part of your organization functionally is experiencing the greatest impact as a result of the changes to the economic environment?
Focusing on the cost management agenda

When it comes to their ability to manage costs centrally, over half of respondents (56%) indicated their organizations have implemented a central group or team to focus on their cost management agenda. The majority of organizations with greater than 5,000 employees indicated they are using a central team to drive their cost management agenda, while those with fewer than 100 employees have the lowest level of adoption of this strategy. In line with the size demographic, the fully integrated companies are the organizations that are leveraging this approach the most.

When it comes to leading practices on sustainable cost management, a key element is effectively centralizing the approach, reporting and enabling processes, but driving decentralized accountability for owning the cost management agenda and delivering results into the business units and functions.

Does your organization have a central group or team focused on a cost management agenda?
Our survey results indicate respondents understand conceptually the impact lower oil prices will have on the industry, and they have made dramatic short-term cuts in response. But few have turned their attention to achieving more sustainable structural change. With a shift in the industry to an era of resource abundance, organizations must move toward more strategic, long-term and sustainable solutions to optimize their operations and achieve a new cost equilibrium.

Why a long-term view is needed

Our survey results indicate respondents understand conceptually the impact lower oil prices will have on the industry, and they have made dramatic short-term cuts in response. But few have turned their attention to achieving more sustainable structural change. With a shift in the industry to an era of resource abundance, organizations must move toward more strategic, long-term and sustainable solutions to optimize their operations and achieve a new cost equilibrium.

What high performance looks like

In this new era, high-performing companies will be the ones that are strategic in their cost management efforts. By seeing the downturn as an opportunity, companies that manage their costs strategically can, in fact, strengthen their positions in the market despite the downturn. By using a diagnostic approach to fully understand the implications of each initiative on their business, and by understanding their cost-value relationships, they can restructure their businesses based on future growth plans and capability requirements. In turn, they will be more likely to realize higher growth and market share, find more cash for value-building opportunities, improve their risk profile and even reaffirm employee confidence.

Experience from previous downturns reminds us that those companies that merely make short-term, tactical cuts to capital projects and headcount, while scaling back growth initiatives and strategic investments, take longer to recover from the impact of those cuts. Companies must manage costs in a strategic, sustainable way, addressing the underlying problems.

High performers will manage their costs strategically and strengthen their positions in the market despite the downturn, challenging themselves around the key elements of high performance set forth in the chart below.

<table>
<thead>
<tr>
<th>High performers</th>
<th>Opportunity</th>
<th>Sustainable</th>
<th>Strategic</th>
<th>Differentiation</th>
<th>Position</th>
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<tbody>
<tr>
<td></td>
<td>View downturn as an opportunity to improve business performance, take market share and change their competitive position</td>
<td>Make fundamental structural changes to increase cash flow and drive sustainable results, avoiding short-term “damaging” decisions</td>
<td>Strategically cut costs to fund growth and meet/exceed shareholder expectations using analytics and business insight</td>
<td>Boldly advance their strategic position by building differentiating capabilities and shedding/acquiring assets and businesses where it makes sense</td>
<td>Anticipate downturns and position for better performance post-recession, with the ability to grow rapidly coming out of this period of low prices</td>
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</tbody>
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A transformational journey for companies in a new era of energy

To sustain meaningful performance, leaders in the oil and gas industry must take a more strategic and longer-term approach to cost management – one that strengthens their position in the market despite a downturn. They must make fundamental changes to increase cash flow and drive sustainable results. They must boldly advance their strategic position by building differentiated capabilities and divesting or acquiring assets where it makes sense. And they must continue to be innovative in how they execute their business.

To achieve results, companies must understand that this new era of resource abundance is an opportunity for structural and transformational change. Everything has changed, and short-term, narrowly focused cost reductions are not a complete solution. Costs matter now more than ever – and a long-term, strategic, sustainable approach to cost management is critical.

Our cost management approach

As the industry reacts with cost-cutting initiatives, the true winners will be strategic and focused, and take a planned and methodical approach to cost management. Companies must think through their ideas and build a roadmap. There needs to be a logical, balanced approach that addresses both short-term and long-term challenges. Cost management transformation must be managed just like any other project – using the right tools and accelerators at each stage – as outlined in our approach below.

Organizations need to have a well-structured long-term cost management approach, versus one that’s tactical, short-term and knee-jerk in nature.
Key success factors

Implementing a sustainable cost management program that enhances a company’s competitive advantage requires building value, pace and sustainability. It’s critical that companies understand which levers have the greatest impact on the business’s cost performance – and which actions adversely impact performance and increase risk. The road to effective cost management is not a sprint – it’s a marathon that requires a consistent pace and thoughtful identification and implementation of opportunities. Sustainable improvements will continue to deliver value in the long term and won’t simply be reversed should oil prices recover.

Below is an example of appropriate objectives and winning elements for a cost management approach within each of the main drivers of success we’ve identified.

### Three main success drivers

<table>
<thead>
<tr>
<th>The right objectives</th>
<th>Winning elements for a cost management approach</th>
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<tr>
<td><strong>1. Value</strong></td>
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<td>The right costs are addressed aggressively</td>
<td>1. Are you aggressively targeting the right levers?</td>
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<td>2. Are you managing the right mix of levers?</td>
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<td><strong>2. Pace</strong></td>
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<td>3. Will you release cash, optimize cost in the time required?</td>
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<td><strong>3. Sustainability</strong></td>
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<tr>
<td>Consideration is given to making the company stronger and more competitive for the longer term</td>
<td>5. Are you confident that the interplay between levers is being managed?</td>
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<td></td>
<td>6. Is there a clear line of sight between tactical and strategic interventions?</td>
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Organizations need to approach cost management at the right pace, and with sustainability top-of-mind.

Examples of high-impact areas where structural cost savings can be achieved include:

- Refinement of fly-in/fly-out strategies
- Game sharing on longer-term maintenance contracts
- System/application rationalization
- Operational excellence
- Shared services
- Application of new technology (integrated operations)
Conclusion

In the midst of a new era of lower oil prices, our survey finds the biggest issue companies are facing is the capacity to run the business with fewer resources while managing costs. While companies appreciate the need to be more structured and strategic in their approach to cost management, most have only implemented tactical and short-term measures. At the same time, companies have not yet really looked at longer-term opportunities, such as technology improvements, process optimization, different business models, innovation, outsourcing or strategic sourcing and contracting. However, these will be the areas where long-term, strategic opportunities exist for structural change and improvement.

Especially in the face of what may be a longer-term drop in prices, organizations must implement a top-down, more strategic, methodical approach to cost management – one that is focused on value, pace and sustainability. There is a unique opportunity in this environment to make strategic changes that will benefit an organization in the long term – but companies must make those changes in a sustainable way to avoid collateral damage in the process.

For more information on the detailed, full results of the survey – and how they may impact your business, contact a member of EY’s Canadian Energy team.

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