

## Finding the Upside in Strategic Risk

Over the past 10 years, Oliver Wyman has seen strategic risk surge to the forefront of management challenges for our clients across many industries. Increasingly, we are finding that one of the key characteristics of successful companies is that they are exceptionally skilled at not only recognizing, anticipating, and managing strategic risks, but in converting such risks into meaningful growth opportunities.

In our new book, *The Upside*, we explore how to anticipate strategic risks, how to prepare for them, and how to transform them—revealing the hidden upside. The following brief perspective focuses on some of the specific strategic risks that we see across the energy industry and how companies can consider mitigating and turning these risks into competitive advantages.

## How Precarious are Energy Industry Business Models?

Today's energy sector has experienced tremendous positive momentum in what has been a very prosperous economic expansion. But even as they make record-breaking profits each quarter, energy companies are facing new challenges: The concept of risk, while not new, is becoming ever more urgent on the agenda of industry leaders. Right now, Oliver Wyman believes it is critical for energy companies to think about risk in a strategic context—well beyond the traditional considerations of catastrophe, terrorism, and the potential for operational failure. Strategic risks going forward will be strongly connected to peaking hydrocarbon prices, new competitors, increased challenges to meeting capital project hurdle rates due to rising costs, requirements for more risky offshore/deep water/pure exploration bets... and on the list goes.

Traditional risk management has focused on three categories of risk: hazard, financial, and operational. Most companies have risk managers that handle these risks. There are other risks, however, that can be even more dangerous and that target one or several elements of a company's business design. Oliver Wyman has identified seven categories of strategic risk that today's energy executive must consider and anticipate: project, customer, transition, brand, industry, unique competitor, and stagnation risk.

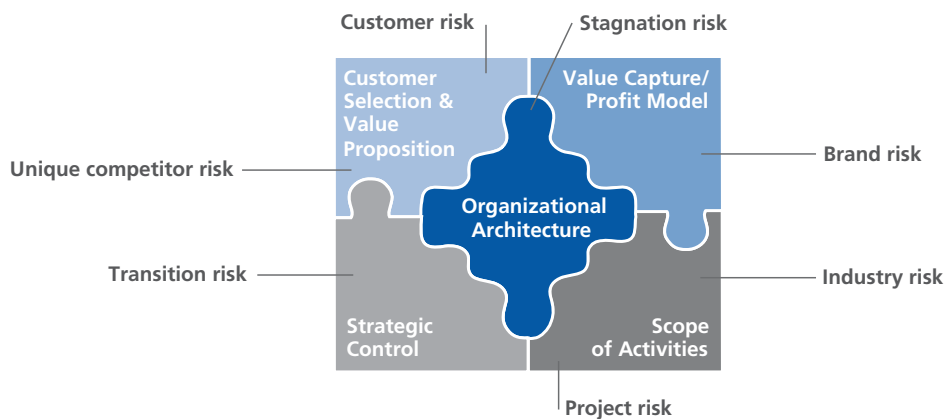
### 1. Project Risk

A very common risk is that a costly investment in a new project or acquisition will fail, particularly if the company does not have a diversified portfolio.

**Example:** Energy and utility companies (e.g., CMS Energy, Dominion, El Paso) built the first four LNG terminals in the United States in the late 1970s and early 1980s. Falling natural gas prices, however, drove the closure of all these plants between 1980 and 1982. Natural prices did not recover enough to allow the companies to reopen the terminals until 2001. This example clearly illustrates the risks companies assume when they make million-dollar investment decisions based on the anticipated prices of commodities, such as natural gas, and thus of the need to manage such bets within the portfolio.

**Today's Risk:** Upstream projects today are getting larger and more complex. The attraction of upstream profits is also driving many companies to consider expanding their investments, moving from investor to operator, or entering into the space from adjacent energy sectors. At the same time, the graying of experienced project managers is reducing available capabilities. These factors combined increase the level of project-related risk within the sector.

### Strategic risks: Impact on business design



**Risk Countermeasure:** To protect against such risks and turn them into opportunities, Oliver Wyman recommends that companies invest in next-generation project management processes focused on large project risk, including a serious review of existing talent management strategies. We believe that companies growing into the upstream sector need to formulate an organizational plan focused not only on new capabilities, but on ensuring well developed processes are in place that can support the evolving organization and enable management oversight into critical investment and operating decisions.

## 2. Customer Risk

Your customer base is decimated by shifts in needs and priorities that make your offering unappealing.

**Today's Risk #1:** In the retail fuels segment of the energy value chain, marketers and distributors are consolidating and gaining power, demanding supply deals with larger price discounts. How do you leverage the shift to larger marketers for your own growth agenda? How does pricing and how do services need to change?

**Today's Risk #2:** Traditional fuel retailers have witnessed shifts in consumer preferences as hypermarkets have entered, driving loss of share for key fueling purchase occasions such as one-stop shopping at big box stores. How can you use joint venturing to compete? How do you become the dominant player for the purchase occasions where you choose to compete?

**Risk Countermeasure:** We recommend that energy companies increase their understanding of the most valuable customer segments—both consumers and marketers/distributors—to ensure that value propositions are well tailored to these customers' needs. We see a shift in energy company capabilities to better analytical understanding and response to customer risk, especially among distributors and other channel partners.

## 3. Transition Risk

Your company gets overwhelmed by an unforeseen change in technology or its business model.

**Today's Risk #1:** Utility companies face significant transition risks as regulators begin considering how to change revenue models to encourage consumers to conserve energy (as part of the overall drive to reduce carbon emissions). Current rate structures compensate utilities for customers' wasteful use of energy. How might this model change if regulators want to pay more to utilities that help customers conserve energy? What business model changes would be needed to adapt to such new regulatory structures?

**Today's Risk #2:** The power generation industry is currently facing an incredible decision point: What will be the energy-producing technologies of choice that are both carbon efficient and can provide sufficient baseload energy to satisfy customer demand? Many new technologies are currently being considered, such as distributed generation, efficient energy storage, virtual generation, IGCC, etc. Are companies staying on top of technology developments and planning for potential major shifts? Which technology will emerge as the leader?

**Risk Countermeasure:** We believe that double betting, whereby a company invests simultaneously in two or more technologies or business models, can help companies hedge and outlast transition risks.

**Example:** Since 1998, Sempra Energy has diversified its investments in the energy value chain in order to double bet and ensure consistent earnings growth. Today, Sempra has differentiated businesses in the areas of regulated gas and electricity delivery, LNG generation, natural gas pipelines and storage, and commodities. By launching these diversified businesses, Sempra realized compound annual earnings growth of 22 percent and saw market capitalization increase by 141 percent during 1998-2006.

#### 4. Brand Risk

The value of your brand collapses suddenly or gradually shrinks in the wake of competitive assaults, disastrous publicity, or a long-term failure to invest.

**Example:** BP witnessed a threat against its brand due to multiple environmental and safety incidents; as one issue was believed to have been contained, another would emerge. Given the industry's record-breaking profits of late, the media spotlight was intense.

**Today's Risk:** More and more oil companies are decapitalizing from the assets closest to customers by exiting company retail operations and leaving much of the customer interface to other channel partners. While the inadequate economic performance of these assets is motivating these shifts, there is a risk in not developing adequate measures and strategies to protect the brand longer-term. What strategies do you employ to ensure you can continue to capture—if not improve—the brand strength that can drive market premiums?

**Risk Countermeasure:** We believe that energy companies need to evolve their brand management capabilities to better understand what factors drive brand equity and value and how best to spend precious brand investments for maximum impact. In some cases, we believe that energy companies can look to successful brands in other industries for lessons and approaches.

#### 5. Industry Risk

Your industry becomes so saturated and competitive that the entire industry turns into a no-profit zone.

**Today's Risk:** The industry is facing a set of new fuels and green momentum. This could cause huge swings in cost structure in a very short period of time, depending on regulatory actions or even customer sentiment. What are the implications for the business models companies employ today?

**Risk Countermeasure:** To counter industry risk, we suggest that companies explore strategic collaboration, outsourcing, or joining forces with their rivals (it is legal) to carry out largely undifferentiated functions or processes.

**Example:** In regulated energy delivery, an industry with low growth rates, TXU has implemented new approaches such as outsourcing most of its support and customer service functions to a third-party provider. With this arrangement, TXU aims to drive significant performance improvement of up to \$140 million in savings, helping the company achieve its aggressive growth targets.

#### 6. Unique Competitor Risk

The sudden emergence of an especially powerful rival decimates your business.

**Today's Risk:** The rise of national oil companies (NOCs) as a more powerful force in the oil and gas industry has been driven by increased nationalism and a desire to capture more value from the energy value chain. Given that the motivations of NOCs extend beyond pure economics to improving the public good, they represent a unique type of industry player. What new methods of working with NOCs can oil companies use to mitigate this risk?

**Risk Countermeasure:** To cope with unique competitor risk, we suggest that energy companies create an “early warning system” to detect emerging threats and give themselves the greatest possible lead time in which to explore ways to manage such threats and potential shifts in business design.

#### 7. Stagnation Risk

Your business achieves a level of maturity that makes further volume and profit growth difficult.

**Today's Risks:** The oil and gas industry faces several types of stagnation risk:

- The exploration and production industries are struggling to replace oil reserves through the drill bit.

- Refiners must find ways to expand marketing channels, in order to facilitate refinery capacity growth and leverage the value of marketing to help maintain refining margins.
- Branded fuel suppliers are increasingly viewing markets from an integrated downstream vantage point, potentially resulting in a more aggressive pricing environment.
- Electric and gas delivery companies face stagnation risk almost constantly, since sources of revenue growth are limited in situations of natural monopoly. Companies need to find sources of untapped revenue potential. What are those sources? How much investment is required to tap into them?

**Risk Countermeasure:** To cope with stagnation risk, we recommend finding dedicated “homes” for incremental volume and demand innovation—such a technique can be used to expand the array of services a company can sell to its customers.

**Examples:** Pemex did this through joint venture refining investments and supply agreements to increase demand for Maya crude. Valero and Tesoro are expanding their branded retail networks to build on network synergies and become more dominant players and brands.

Regulated utility companies also have untapped sources of revenue potential. New earnings contributions of as much as \$50 million could be realized from hidden assets such as joint pole and attachments, PCS towers, real estate assets, and damage claims and collections. This opportunity is especially appealing, since the investments needed to realize the revenues are already in place.

## Reaping the Rewards of Risk

The overall universe of strategic risk is expanding and the market is unforgiving. Oliver Wyman actively works with energy companies to counter risk through enterprise risk mapping, mitigation planning, and industry-leading thinking and research on how companies can not only reverse but find the upside in strategic risk.

Oliver Wyman helps boards and senior management:

- Achieve visibility and understanding of strategic risk and its financial implications, as well as links between enterprise risk management (ERM) and strategy
- Achieve cost effectiveness by fixing problems today versus at the time of crisis (cents versus dollars), and identifying valuable quick hits
- Engage and mobilize management on risk to identify a comprehensive set of risks for focus, assess size and probabilities, and work against the feeling that “we can’t do anything about it” or “that’s just the business we’re in”
- Bring together cross-functional groups with linked responsibilities to address common risks and organizational roadblocks
- Move beyond a “checklist” mentality of risk management to explore strategic alternatives
- Shift to a comparable risk-return decision-making process, within an integrated and common framework
- Emphasize integrated risk identification and mitigation, risk sizing and trade-off modeling, and/or capability development ❖

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## **Oliver Wyman**

Oliver Wyman is building the leading global management consultancy, combining deep industry knowledge with specialized expertise in strategy, operations, risk management, organizational transformation, and leadership development. The firm works with clients across a range of industries to deliver sustained shareholder value growth. We help managers to anticipate changes in customer priorities and the competitive environment, and then design their businesses, improve their operations and risk profile, and accelerate their organizational performance to seize the most attractive opportunities.

We would be pleased to discuss with you our perspectives on managing strategic risk. For more information, please contact your Oliver Wyman account representative, or one of our energy team leaders:

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