

Get Serious About Strategic Planning

With energy prices at record highs, oil and gas exploration and production companies have grown complacent about long-term growth. It's time to get serious about strategic planning in order to map out the high-priority initiatives that will drive the next wave of value growth.

Higher energy prices have been driving up shares throughout the oil and gas exploration and production (E&P) industry. But even if energy prices continue to rise, these good times cannot last forever, and shareholders will eventually demand something more tangible than a promise of ever-increasing energy prices. Sooner or later, investors will gravitate toward E&P firms with the best strategies and plans to create sustained value growth—predicated, that is, on the best strategic plans.

E&P firms already employ some form of strategic planning, of course, but many have been overwhelmed by the rapid run-up in energy prices; they are inundated with cash, which disrupts any capital budget process that relies on cash-flow data from the previous year or two. Excess cash sounds like a good problem to have, but today's fat times have essentially stalled the strategic planning process and left management teams less certain about which paths to take for longer-term growth, as executives have focused on short-term execution.

Cash-rich E&P firms have an opportunity—indeed, an obligation—to examine and revise the way they plan for the next stage of growth. Beyond the next earnings report, how can they create long-lasting value with substantive projects in their core business divisions? Since most of the easier growth

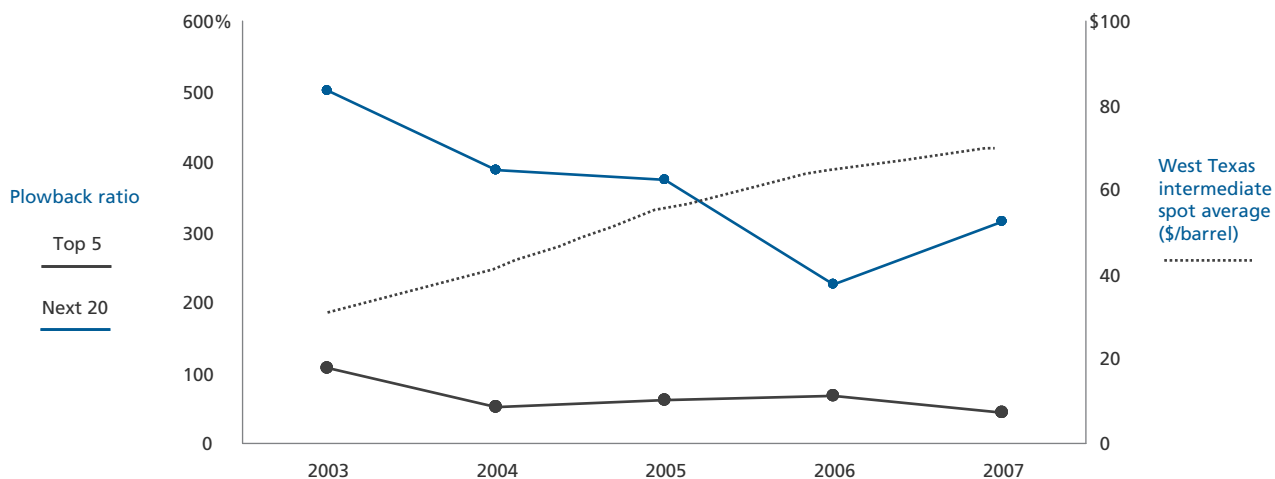
opportunities are already being captured, executives should consider a more sophisticated and comprehensive approach to strategic planning, one that includes advanced business analytics (such as sub-surface and above-ground risk assessments) and risk appetite benchmarking.

The Case for New Value Growth Strategies

E&P companies have traditionally faced capital constraints, which helps explain why many of them lack longer-term growth plans by which they could properly deploy cash and drive shareholder value growth. During previous periods of high energy prices, E&P companies turned to the proven technique of “plowback” investments in their own operations, in order to dispose of excess cash. For example, between the 1980s and mid-1990s, E&P companies plowed back large amounts of cash, allowing them to pump more oil from existing wells, drill new wells, and broaden their search for exploration and production prospects.

The current market departs from these historical norms. In 2007, the top five E&P majors further reduced the percentage of available cash used to fund new exploration or finance new capital projects (Exhibit 1). The next 20 firms slightly elevated their plowback ratios in 2007, but they remain at levels significantly lower than in 2003-2005.

Exhibit 1 **Plowback ratio – lagged %**



Note: Plowback ratio calculated for each company as total costs incurred / EBIT, or (acquisition costs: proved + acquisition costs: unproved + exploration costs + development costs) / (gross revenues: op. and non-op. - (total costs and expenses - total net interest expense - dividends on pref. stock outside equity base)). EBIT is one year behind total cost incurred. Source: Company annual reports and Oliver Wyman analysis.

The current lower plowback levels suggest two possibilities. First, some E&P senior management teams may believe that their traditional strengths—an intrinsic ability to find and produce oil and gas reserves—no longer guarantee future performance. Second, some E&P companies may be waiting for the market to cool down and yield lower construction costs for capital projects already on the books. While construction costs are high, some level of stock buyback may make sense, but share repurchases will not drive differentiation or value growth over the long term.

Moreover, while E&P firms may be stalling new initiatives, other industries around the world have done exactly the opposite and shifted into high gear. Hypergrowth in China and India has helped push steel prices to record highs, but steel mills throughout the world continue to accept new orders. If and when major energy companies decide to begin plowing back larger investments for new upstream or downstream operations, they may incur a hefty penalty for the months or years they waited. They may have to pay more not only for scarce materials, but also for qualified professionals who are enjoying a sellers' labor market that shows no signs of abating.

The evidence suggests that cash-rich E&P companies should complement their stock buybacks with a more holistic approach to longer-term strategic planning, which will help them capture the next wave of value growth for their core business.

Why Strategic Planning Matters

The power of strategic planning lies in the attention focused on guiding an organization's direction over a defined period of time, typically from one to seven years. When implemented along with in-depth reviews of potential risks and returns, a strong strategic plan can prepare an organization to prosper in all types of environments, including long periods of sustained high prices or low prices.

While many E&P companies do participate in strategic planning, the levels of application, effectiveness, and rigor vary considerably. Most firms implement at least a baseline process to help identify invest-

ment opportunities that best match their intrinsic skills at finding and producing hydrocarbon reserves. However, the best-managed companies consider their strategic planning systems to be a competitive advantage and use them to achieve three goals:

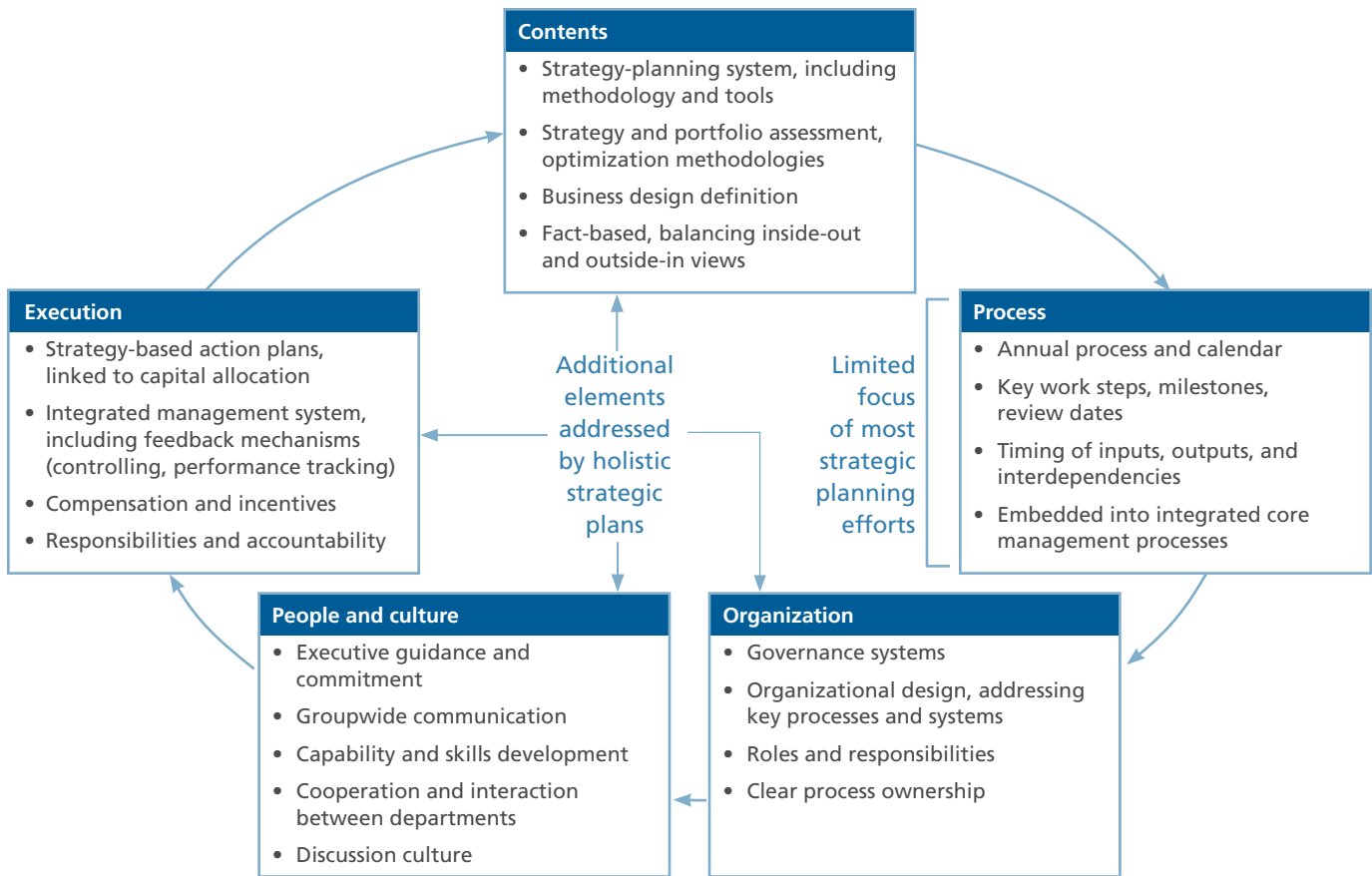
- Establish vision expectations
- Build consensus for supporting high-priority initiatives
- Align resource deployment across the business

By leaving as little as possible to chance, E&P companies that practice superior strategic planning rarely find themselves scrambling to identify where or when to invest their excess cash flow. Given a specific set of market circumstances, they already know which initiatives hold the most potential and make the most sense.

E&P companies looking to develop the next wave of value growth strategies are best served by an integrated strategic planning system, a holistic approach that ties strategy to the precise way the business actually runs. Most strategic planning approaches focus primarily on process. By contrast, as shown in Exhibit 2, a holistic approach considers more than process and links elements ranging from content and organization to culture, people, and execution. Holistic planning does not isolate the process in a vacuum; instead, it identifies, analyzes, and considers all factors that could potentially affect the business.

Moving to an integrated and more rigorous short- and long-term strategic planning approach has several benefits. To start, as the company grows, laying out a longer-term blueprint can ensure access to the resources and assets required for growth, particularly in tightening markets for labor and materials. Armed with effective strategic planning, companies can gain a deep understanding about how to secure critical inputs, including the capital assets, skilled workforce, and supplies required to execute projects and achieve the desired goals.

Exhibit 2 Strategic planning system



In addition, holistic strategic planning enables firms to optimize their portfolio by balancing various factors—gas vs. oil, geographies, deepwater vs. onshore, and so on. Through more robust planning systems, firms can improve their portfolio modeling by defining when and where specific projects should be triggered.

On the budget front, migrating from an annual budget focus to a longer-term planning focus can make an organization more adept at allocating capital, tracking business, making mid-course corrections as markets change, and selecting sound strategic directions.

Where to Begin

To create an effective holistic strategic planning system, we have found it useful to go through a process that involves every layer of the organization and includes built-in checks to help overcome common implementation challenges. Typically, this process should include five steps:

1. Perform an internal audit. Just as every oil or gas well has its own set of quirks and features, every E&P company has a distinctive culture that will influence the outcome of its strategic planning processes. It's worth investing the time and effort to complete an internal audit to pinpoint where your company stands on a "maturity spectrum," as shown in Exhibit 3, which assesses elements ranging from long-range vision to internal metrics and compensation systems. Integrating holistic strategic planning into an existing corporate culture cannot be done by decree; instead, to ensure the best results, the planning system must correspond to the characteristics of the company and its people. The results of a comprehensive internal audit will help the company make informed decisions about which changes or innovations match up well with the company, and which should not be attempted.

2. Apply best-practices experience. An assessment of best practices provides the company with a powerful frame of reference after it reviews the data and evaluations gained from the internal audit. The best-practice review points managers toward the strategies and applications that will have the best chance of succeeding, allowing the management team to proceed with confidence (rather than caution or concern) as a holistic strategic plan takes shape.

3. Design parameters and build consensus. Every company must draw careful distinctions between what it wants in a new strategic planning system—and what the organization can feasibly handle. Using the outcomes from the first two steps, the senior management team can develop a list of high-priority action items that matches the time and resources the company can allocate to strategic planning. The goal is to develop a clear picture of what the company is capable of handling amid the

Exhibit 3 Strategic planning maturity spectrum

	← Basic	Level of practice	Best →
Vision (10+ yrs)	<ul style="list-style-type: none"> No or limited articulated view of the future state of the company 		<ul style="list-style-type: none"> Clearly articulated and understood throughout the company Differentiated, based on core competencies and future market belief
Top-down guidance	<ul style="list-style-type: none"> Corporate strategy and priorities are not unified Limited engagement from leadership team with strategic planning group 		<ul style="list-style-type: none"> Clear corporate strategy and priorities with leadership and engagement by senior executives Differential business unit expectations based on portfolio perspective
Planning processes and horizon	<ul style="list-style-type: none"> Calendar-driven, starts over every year Short-term horizon (1 to 3 years) Limited accountability and look-back Limited, basic market data 		<ul style="list-style-type: none"> Evergreen, builds from year to year Clear planning process where strategy drives other processes Integrated across short- and long-term (up to 20 years) horizons Focused on action items, accountability, and look-backs Consistent assumptions based on extensive market data
Planning approach	<ul style="list-style-type: none"> Limited focus on drivers of assumptions and alternative scenarios 		<ul style="list-style-type: none"> Prioritized playbooks with defined boundaries. Scenario development and signposts
Strategic planning organization	<ul style="list-style-type: none"> Performed exclusively by geographic business units 		<ul style="list-style-type: none"> Matrixed—centrally directed with integrated input and development from geographic business units Lead planning and analytic capabilities development
Capabilities	<ul style="list-style-type: none"> Basic E&P economics 		<ul style="list-style-type: none"> Deep knowledge of key markets, geopolitical forces and macroeconomic trends Portfolio and probabilistic modeling Commercial acumen Organization engagement and communications
Portfolio modeling	<ul style="list-style-type: none"> Project ranking Focus on capital constraints and reserves replacement 		<ul style="list-style-type: none"> Portfolio optimization and management Optimize over time across financial/operating constraints, reserves replacement, and human resource constraints
Metrics and compensation	<ul style="list-style-type: none"> Primary focus on reserves and production Short-term compensation systems Clear metrics but without tactical action plans Informal performance tracking 		<ul style="list-style-type: none"> Focus on profit and value growth Value-driven, long-term compensation systems Metrics involve action plans for how to hit targets Performance tracked through balanced scorecard
Culture	<ul style="list-style-type: none"> Limited debate and constructive challenge across company 		<ul style="list-style-type: none"> Transparent, open strategic planning processes with constructive challenge and consistency across industry cycles

disturbance that accompanies any company-wide change or new approach.

4. Design the core strategic planning process. The data and answers developed up to this point provide the process design team with the necessary parts and raw material. Now it's time to design the precise fits and interrelationships that will be required throughout the organization. This step creates a map for the processes and the people, leaving no implementation questions unanswered.

5. Test and learn. A strategic planning system should be viewed as an evergreen process, which needs to be revisited and reassessed over time. Built-in parameters will flag when changes in internal and external variables demand a recalibration of the process. Incorporating new insights into each successive planning cycle will help ensure that the management team remains attuned to changes in the environment

that warrant fine-tuning of the system.

Taking these steps ensures that companies continually measure results against their plans, align their organizations to make ongoing planning processes more successful, and translate their strategy into the day-to-day operations of the business.

The result should be a competitively advantaged, holistic strategic plan that can help E&P firms reap short-term rewards while simultaneously steering them toward long-term gains. Investigating and adopting a new business model is not easy, but the current environment of high energy prices and strong cash flow gives E&P companies a window of opportunity. Without a robust strategic plan, E&P companies risk making uncharted moves during this remarkable period of sustained high prices and shortchanging their shareholders with poor value growth over the long term. ❖

Incorporating Elements of Risk

Risk analytic and modeling elements form critical gears that drive an effective strategic planning system. Oliver Wyman, for instance, typically builds "gearboxes" that mesh five separate systems to produce sound strategic decisions. The five systems are these:

- Internal risk analysis of strategic, operational, and organizational factors
- External risk analysis of macroeconomic, competitive, political, and counterparty factors
- Quantitative metrics for material risks across the portfolio, including downstream vs. upstream operating units, geographic regions, and so on
- Risk adjustments on key metrics (e.g., Weighted Average Cost of Capital (WACC) and investment hurdle rates) for all risks and risk drivers for each investment option under consideration
- Risk-return portfolio modeling of how the portfolio should migrate over time in accordance with specific plan goals, ensuring that management will neither overpay for potential strategic gains nor underestimate the potential risks of any new investment

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About the Oil and Gas Practice

Oliver Wyman's Oil and Gas practice defines itself by the value it creates for clients. Our advanced analytics combine with deep industry expertise and our willingness to work side by side with clients to ensure that the right opportunities are pursued with the best tools in a cost-effective way.

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