Navigating the lower-for-longer oil price cycle

Senior analysts at consultancy firm, Oliver Wyman, suggest five steps for achieving sustainable cost optimisation in the oil and gas industry

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Oil and gas operational excellence is composed of several critical factors that must be managed in an integrated way to sustain a high level of operating performance. The main factors are safety, reliability, well productivity, operational efficiency, and cost optimisation. These all combine to determine the economic viability of a well or a drilling programme under a given set of market conditions.

It is crucial to have a well-defined strategy on the journey towards achieving meaningful operational excellence. Here, analysts at Oliver Wyman make five key observations.

1. The oil price downturn increased profitability pressure

Since 2014, the oil and gas industry has found itself in a new market environment, with oil prices dropping by more than 60%. In an industry accustomed to prices in the US $80-$120 per barrel range, the new price cycle of $40-$60 per barrel led to a significant decrease in profitability, impacting shareholder value.

Companies with the lowest break-even prices will be the winners in the long run. For national oil companies (NOCs), the oil price drop adds to the pressure on profits, given the important role oil plays in supporting the local economy and government budgets. Indeed, some oil exporting countries have seen oil revenues drop by more than 50%.

2. Operations excellence and cost optimisation are critical

NOCs are increasingly implementing ambitious cost optimisation programmes, with the objective of reducing their cost base by at least 20%. In Europe, Statoil has already achieved a 20% OPEX reduction through right-sizing, and reorganisation. In Russia, Gazprom has reduced the cost of gas production by more than 30%, taking advantage of its share of Ruble-based contracts. In the GCC, the Abu Dhabi National Oil Company (ADNOC) has set an ambitious cost optimisation target of 20%, having already started to deploy initiatives such as right-sizing, and taking advantage of the supply base market opportunities to renegotiate contracts.

3. Sustainable cost optimisation has five characteristics

Analysing this and previous downturn cycles, Oliver Wyman has identified five levers that are common in oil and gas companies

Figure 1: Evolution of Brent crude prices 2012 – 2017, US$ per barrel.

Figure 1

1/2/2012 1/2/2013 1/2/2014 1/2/2015 1/2/2016 1/2/2017

Then

Now
that thrive at achieving sustainable cost optimisation. The firm developed a pragmatic cost optimisation approach based on these levers. The deployment of this approach should be adjusted to each company's situation, objectives, capabilities, and culture.

**a. Set ambitious targets and obtain top management buy-in**

Perform a high-level cost due diligence, across assets and peers, to set a cost optimisation target, and then promote it throughout the organisation.

**b. Plan which areas to optimise using pragmatic methodologies**

Follow a structured and systematic approach to identify key areas for improvement and potential quick wins. One pragmatic method is to develop a profitability tree, mapping the key cost drivers and identifying the areas to focus on. It's important not to cut costs equally across the board.

**c. Develop pragmatic cost optimisation initiatives**

These must be impactful and implementable, such as initiatives that:
- focus on eliminating redundancies, reducing demand, and finding alternative supply options.
- focus on renegotiating supply contracts, consolidating volumes across sites, standardising specifications, and deploying total cost of ownership (TCO) for key spending categories.
- focus on localisation, low-cost country sourcing, or outsourcing. These types of initiatives are being deployed across the board.

**4. Ensure delivery using robust performance management**

Cost optimisation initiatives and targets should be monitored to ensure the savings are captured and not spent elsewhere. As an enabler, it is also important to create the right level of cost transparency in the organisation. For example, the CEO of one GCC NOC...
**ANALYSIS**

**Figure 2 – NOCs’ cost optimisation target and initiatives (based on public information)**

<table>
<thead>
<tr>
<th>NOC</th>
<th>Cost reduction target</th>
<th>Initiative Details</th>
</tr>
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<tbody>
<tr>
<td>ADNOC</td>
<td>25%1</td>
<td>Reduce CAPEX and Capex, large workforce reductions.</td>
</tr>
<tr>
<td>Saudi Aramco</td>
<td>20% Estimated2</td>
<td>Multiple initiatives across the company.</td>
</tr>
<tr>
<td>QP</td>
<td>15-20%3</td>
<td>Various initiatives, including staff reductions.</td>
</tr>
<tr>
<td>K-Companies</td>
<td>20%4</td>
<td>Multiple initiatives, including CAPEX reduction.</td>
</tr>
<tr>
<td>Statoil</td>
<td>30%4</td>
<td>Various initiatives, including Capex and OPEX reductions.</td>
</tr>
<tr>
<td>Gazprom</td>
<td>25-30% Capex/Opex</td>
<td>Various initiatives, including Capex and OPEX reductions.</td>
</tr>
<tr>
<td>Petrobras</td>
<td>NA</td>
<td>Various initiatives, including Capex and OPEX reductions.</td>
</tr>
<tr>
<td>PDVSA</td>
<td>50% Capex</td>
<td>Various initiatives, including Capex and OPEX reductions.</td>
</tr>
<tr>
<td>Sonangol</td>
<td>NA</td>
<td>Various initiatives, including Capex and OPEX reductions.</td>
</tr>
<tr>
<td>NNPC</td>
<td>30% Capex/Opex</td>
<td>Various initiatives, including Capex and OPEX reductions.</td>
</tr>
<tr>
<td>Pertamina</td>
<td>20% Capex/Opex</td>
<td>Various initiatives, including Capex and OPEX reductions.</td>
</tr>
<tr>
<td>Petronas</td>
<td>NA</td>
<td>Various initiatives, including Capex and OPEX reductions.</td>
</tr>
</tbody>
</table>

- **Cost reduction** for CAPEX and Opex major oil projects.
- **Cost Optimization Program** (Category management, etc.)
- **Large workforce reduction** across multiple locations.
- **HR and performance initiatives**
- **Procurement automation**
- **Business unit consolidation** (e.g., ADNOC ZADCO)

**Case Study**

In response to rising costs and declining oil prices, Petrobras launched an industry-wide programme, CORAL 2.0 (Cost Reduction Alliance), involving 25 operators. Under CORAL 2.0, there are 11 identified initiatives to activate three value levers – proactive demand management, spend consolidation, and driving innovation. CORAL 2.0 aims to inculcate a cost-conscious culture across the industry, to promote international performance benchmarking, and to increase collaboration in exploration and production. This programme has a targeted potential annual cost saving of $2.1bn to $2.7bn by 2019, has already enabled Petrobras to reduce CAPEX by 28%, and OPEX by 9% from 2015 to 2016.

**Figure 3 – Oliver Wyman’s cost optimisation approach**

- **Set an ambitious target and obtain top management buy-in**
- **Use pragmatic methodologies and identify which areas to optimize** (no-one size fits all)
- **Develop pragmatic cost optimization initiatives**
  - Do Less: Eliminate processes/layers/services/products
  - Do better: Optimize asset footprint/standardize
  - Do cheaper: Switch to cheaper suppliers
- **Ensure delivery** through a robust performance management and communication
- **Align organization** ensuring buy-in and deploy a cost performance culture

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1. Profitability tree breaks down a company’s free cash flow into its main drivers [i.e., revenues, OPEX, Capex, and working capital].
2. TCO – total cost of ownership considers all direct and indirect costs associated with a given purchase throughout its life cycle.
3. IKTV – In-Kind Total Value Add Program to baseline, measure, and support increased levels of localization in the Kingdom of Saudi Arabia.
4. Based on investors’ presentations.