Oil and Gas Investor

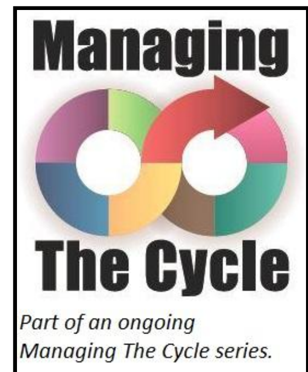
Getting The House In Order

SETH TYLER, JOHN SAUCER, DANNY RUDLOFF AND JAMES DELOACH, SPECIAL TO HART ENERGY SUNDAY, MARCH 1, 2015 - 1:00AM

As crude oil prices continued to fall in January, E&P executives reacted quickly with revised capital budgets, salary freezes, reduced drilling plans, even staff layoffs. However, some analysts began to question the timing and strength of these changes, saying much more adjustment

would be needed. Some even claimed that executives were still in denial about the severity and duration of the downturn.

No one knows how 2015 will unfold, but are there more nuanced steps E&Ps can take to weather the storm? We asked some consulting experts to submit their views on which tactics and strategies E&Ps should consider this year, in order to be teed up for the hoped-for oil price recovery in 2016.



Part of an ongoing Managing The Cycle series.

Having an appropriate hedging strategy goes without saying, but knowing what to do and when to pull the trigger is the bigger issue. Likewise, this is a good time to pull back from the frenzied pace of the past few years, when E&Ps focused on growth at almost any cost.

To conserve capital and improve rate of return is important, but these experts argue that it is time to look deeper into what the organization is doing well and consider what it should do differently. Are goals realistic? Is the appropriate staffing in place or is this the right time to fill in some holes?

Here, in their own words, are points to ponder from Seth Tyler of Evolve Partners LLC, John Saucer of Mobius Risk Group and Danny Rudloff and James DeLoach of Protiviti, each based in Houston.—The Editors

Evolve Partners On Improving The Organization

Low oil prices present an extensive array of challenges for oil and gas producers. The situation is similar in some respects to the drop in natural gas prices after peaking in 2008. Of course, many companies dealt with that price challenge by increasing their oil portfolios. However, many others used that price pressure to put in place significant improvements in their organizational effectiveness, allowing them to realize sustainable margins from gas, even at depressed prices.

Beyond the need to repay debt and sustain dividend payouts, the overarching challenge now is how to allocate capital and optimize cash in a low oil price environment. Many companies have already reduced capital programs for 2015 to preserve cash. But the current price swoon offers a compelling external impetus for change and expands capacity to allow time to work on organizational improvements. Progressive firms will seize this as an opportunity to drive sustainable changes to culture and capabilities in

the long run, while capturing cash and margin benefits in the near term. This proactive approach will generate significant profit and capital efficiency benefits when prices recover. The following are five things companies can do to take advantage of the current price environment:

Focus On Profitability and Margin

Do you know the profitability of each individual well, pad or area, and is that profitability driving your development plan and daily operational activities? For most companies, that is clearly their intent, but it may not be their actual reality in terms of current practice. Behaviors, systems and processes haven't necessarily caught up to a margin-driven intent during the past several years, because companies have been very focused on growth and lease-holding strategies.

The current ebb in capital budgets creates a great opportunity to mine available data—or to start to define and collect the relevant data—to prioritize and concentrate development areas, while also ensuring surveillance activities are margin-driven. Achieving this may require some organizational realignment of goals, processes, systems and behaviors.

Evolve Partners COO Seth Tyler said progressive firms will seize this oil price environment as an opportunity to drive sustainable changes.

Analyze And Fine-Tune Process Capability

We recently helped one unconventional client analyze a trove of historical performance data, looking at actual development process stage times vs. targets, and running regression analysis to identify the biggest determinants of development success. We then helped them interpret the data against anecdotal observations of where the process was working particularly well or not.

This yielded some very useful insights into how they could optimize their overall concept to production development process, leverage their full process capability, and prioritize improvement efforts.

In heavy growth mode, it is often difficult to devote attention to this type of analysis. If organizational capacity is a little less stretched, this analysis can help fine-tune the development process for near-term benefit and a jumpstart when the environment picks up again.

Optimize Production

Right now it's all about the production base. However, today's base is not tomorrow's base. The need to overcome significant well depletion curves requires efficiency improvements in both development and base business to preserve and, more importantly, grow the base profitably.

Some of our clients have seen that base production operating efficiency can actually replace or delay capital expansion. Particularly since many unconventional onshore fields are now reaching a certain level of operational maturity, this is an ideal time to ensure that all of the fundamentals of base operating efficiency are in place and driving performance. This includes exception-based surveillance, integrated operations, loss accounting and root cause analysis, and effective maintenance and engineering.

For many unconventional producers, the basic blocking and tackling of operations may be in place, but haven't received the same level of focus as development. Now is the perfect time to create a strong operational engine. What is a 5% or 10% increase in operating efficiency worth to your business?

Rationalize The Supply Chain

More than a few executives we interacted with in the second half of 2014 quietly indicated oil price reductions would create some welcome opportunities in the supply chain. With services moving from a sellers' market to a buyers' market, the most obvious way to do this is to leverage the current environment for better pricing and service terms.

Many companies will do this, but how do you utilize that data to get the most out of this reset? Across-the-board cuts may be appealing, but these may be counterproductive when activity picks up again.

There are further opportunities to look at rationalizing the entire supply chain, including vendor selection, procure to pay, inventory management and logistics.

Now is a great time to look at warehouse strategies and fleet management. For example, one of our clients realized very significant savings by rationalizing and optimizing its water-hauling routes and the way it managed field materials.

Focus On Continuous Improvement And Developing Leadership

With the very rapid curtailing of planned capital expenditure, most companies should find themselves with some degree of excess organizational capacity, but they will be reluctant to make any significant staff reductions, for fear of being caught short (and damaging reputation) when prices start to recover.

This staff capacity can be used for the aforementioned exercises and for broader continuous improvement programs, both technical and organizational. Availability isn't a skill, but with the right type of support and direction, these teams should be able to deliver significant improvements and develop capabilities that will continue to reap rewards when the market rebounds.

During the last oil price drop in 2009, one of our unconventional clients doubled down on its continuous improvement and operational excellence programs. This enabled it to manage margin in the short term, while positioning it to maximize profit opportunity when prices began to recover.

Mobius Risk Group On Hedging

In a low oil price environment, operations executives are rarely forgiven for not meeting production commitments in the annual business plan even when capex is constrained and opex (operating) budgets are reduced. Low oil prices are not a good thing, to be sure, but companies can use the urgency and capacity presented by the current environment as an opportunity to improve their organizational effectiveness for the short and long term.

The second half of 2014 was a tough year for energy companies exposed to oil and gas price declines. Early in the year the steep backwardation in forward prices, where future prices were at a discount to the present, discouraged long-term hedges. Producers were reluctant to lock in sub-$80 prices 24, 36 or 48 months forward when prompt WTI was trading near $100 a barrel. As a result, many companies are behind on their hedge volume targets as prices extend their six-month decline.

Fixed price hedging is particularly difficult with markets well below most companies' budget and planning estimates. The 50% decline in WTI prices creates the perception that the risk vs. reward of locking in prices, via price collars or fixed price swap sales, is less appealing and more expensive, given the opportunity cost of forfeiting potential price upside.

Hedge Restructuring

"It is always important to use whatever the market 'gives you' to improve the performance of your hedge strategy."
John Saucer, Mobius Risk Group

Producers face important choices in 2015, but sitting tight and waiting it out is not a sensible one. It is not about picking a bottom, or selling the high in prices, but rather, taking the steps necessary to strengthen a firm's capital structure to meet funding and liquidity needs. It is also about transparently delivering the predictable revenues pledged to lending banks, and returns to investors, whether public or private.

For producers with hedges in place, the drop to below $50 WTI creates an opportunity to restructure their risk management approach and shift unrealized hedging gains toward capital expenditures, debt reduction and investor dividends. For companies that are unhedged, or merely behind on their hedge targets, it is not too late to strengthen and underpin their capital structure by managing price and revenue risk. The optimal approach for both groups is the same: greater focus on option-based strategies that provide defined downside price insurance, or a floor for prices, rather than merely locking in current price levels.

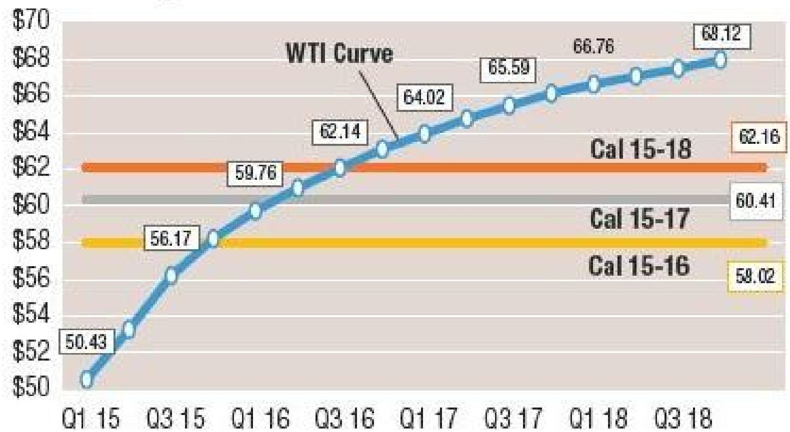
Greater Optionality In Hedges

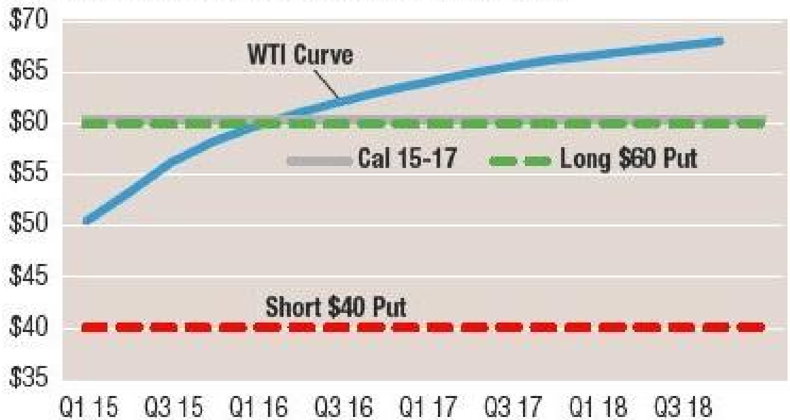
This hedging approach would involve the purchase of put options to provide a defined floor for prices at a defined option premium cost. Given the recent sharp rise in implied option volatility, and option pricing, purchasing put option spreads is a less expensive alternative that provides downside price insurance, but no set floor for prices.

A firm would purchase a long put option at a strike price in line with company requirements and sell a put option at a strike well below current trading levels. The long put would provide protection for prices down to the lower put strike sold for a fixed amount of option premium paid. The option spread approach takes advantage of the currently firm "put skew" in the crude options market where the implied volatility for out-of-the money put strikes is trading at a significant premium to at-the-money strike prices.

Low Interest Rates And Contango

Deferring the option premium can also be an attractive alternative at present. This approach provides greater cash management flexibility by deferring the payment of the option premium from upfront, to a monthly as-used basis. Paying option premium on a deferred basis also takes advantage of low interest rates, and potentially for some companies, the expanded counterparty credit from existing positive marked-to-market hedging gains.





Source: Mobius Group

The significant forward price premium from the crude market's deep contango provides opportunities to layer in price floors and hedges at significantly higher prices.

It is always important to use whatever the market "gives you" to improve the performance of your hedge strategy. At present, the significant forward price premium from the crude market's deep contango provides opportunities to layer in price floors and hedges in general at significantly higher prices 36 to 60 months forward. Calendar 2016 WTI is trading at $12/barrel over the nearby WTI futures contract while calendar 2017 and 2018 are trading at premiums of more than $15 and $17, respectively.

Protiviti On Focusing Your Board's Risk Oversight

The risk oversight of the board of directors is a vitally important process in an ever-changing world, particularly in the oil and gas industry.

But, how do you ensure this process is focused appropriately in the current oil and gas environment?

We believe the answer lies with five broad risk categories recommended by The National Association of Corporate Directors. These apply to every company, regardless of its organizational strategy and unique risks. We discuss each category below.

Governance Risks

Periodically, boards of directors must consider CEO selection and compensation, board leadership and composition, board structure, and other governance issues critical to the enterprise's success.

Often, these decisions require directors to weigh the risks and rewards associated with alternative courses of action.

Board-Approval Risks

These approvals may be directed to either specific transactions or parameters within which senior management makes future decisions. These matters often include strategic initiatives, raising capital for oil and gas plays and specific policy matters, as well as proposed acquisitions, divestitures or major capital expenditures.

Critical Enterprise Risks

These are the risks that could be so disruptive that they could threaten the validity of strategic assumptions and the viability of the business model.

The criticality of these risks—such as significant regulatory issues, geopolitical uncertainty, commodity price volatility and capital availability for upstream exploration and production operators—requires full board engagement as well as an ongoing management process to identify, mitigate and monitor them.

Business Management Risks

These are the myriad operational, financial and compliance risks embedded within oil and gas operations that are not considered critical enterprise risks.

Emerging Risks

These are risks not included in the above categories. For example, they might include effects of new geopolitical developments, climate change, catastrophic events and new security threats.

Adapting is a game every organization must play to survive and thrive, and requires consideration of five broad risk categories, according to James DeLoach (top) and Danny Rudloff, managing directors at Protiviti.

These risk categories can be used to focus how the board organizes itself for risk oversight. To illustrate:

Governance risks fall within the domain of the board, and board-approval risks require directors and management to agree on the matters the board approves in advance and the timing of board involvement with such matters.

The lion's share of the board's risk oversight agenda is directed to the critical enterprise risks and the processes the organization has in place to identify emerging risks.

For critical enterprise risks, the board might expect management to report on the status of risk mitigation efforts and periodically obtain input from executives who have direct responsibility for managing these risks.

With respect to business management risks that are not considered to be critical enterprise risks, the board should expect escalation of significant issues on a timely basis and periodic briefings in specific areas over time.

The board should identify specific categories of business risks that pose the greatest threats and determine whether to oversee each category either at the full board or board committee level. For example, the audit committee traditionally oversees financial reporting risks, and the finance committee might oversee risks related to strategic opportunities, commodity price exposures and capital availability.

And there are other business risks to consider, such as risks associated with information technology, intellectual property, environmental matters, health and safety, regulatory compliance and reputation.

Disruptive change arising from technological developments, geopolitical market forces and other unexpected threats is a business reality in oil and gas.

Adapting is a game every organization must play to survive and thrive in a rapidly changing business environment. Properly focused, the board's risk oversight process can assist senior management in adapting the organization successfully to changing markets.

Seth Tyler is COO of Evolve Partners LLC in Houston. John Saucer is vice president, research and analysis, with Mobius Risk Group in Houston. Danny Rudloff is managing director with Protiviti, global lead for its energy practice, and head of the Houston office. James DeLoach is a managing director at Protiviti, also based in Houston.

Copyright 2015 Hart Energy. All rights reserved. Reproduction in whole or in part, in any form or medium without express written permission is prohibited.