Drilling down: Looking forward from the eye of the storm

In this edition of KPMG Global Energy Institute's Drilling Down, we talk to Olli Valikangas, Principal, KPMG Strategy U.S. and Richard Metzner, Managing Director, KPMG Strategy U.S., about what companies are doing or can still consider doing as the market impacts of COVID-19 and the collapse in oil prices have reverberated through the value chain.

While talk of phased re-opening picks up, the US shelter-in-place restrictions of the past weeks have crushed demand, strained storage options and driven down oil prices, which of course were under pressure even before COVID-19. What have upstream operators done to respond so far?

E&P companies are inherently resilient and ingenious because of the cyclical nature of the industry. As the saying goes, "This isn't their first rodeo." As a result, most companies turned to their playbooks from prior downturns and quickly pulled cost levers, laying down rig activity, stopping third party-spending and, in some cases, making reductions in force.

In addition to pulling hard on traditional cost and capital levers, the painfully low price environment (not to mention a slip in to negative territory for the first time in history on April 20) has increased the focus on shut-ins, sometimes self-directed by the producer but at other times as the result of force majeure declarations by off-takers.

No doubt these actions have resulted in savings. Sadly, at current prices not enough for all players. We believe however, that for most, more potential remains to take action now without significant disruptions to day-to-day operations.

Since so many operators have already undertaken efforts to cut costs, why should they still be considering doing more and how is that different from the actions they've already taken?

First, operators should remember that for those who have yet to apply for aid under the CARES Act, there are still funds available under new tranches the government has just opened. Those funds could provide immediate relief for eligible businesses. On a more surgical level – by that I mean more data-driven – there is no doubt we are in a stressful and tumultuous time, but in some respects this is also a time to get your data in order and use that to move from experience-based gut feel decision making to deeper, more informed insights that can provide the basis for better decisions. For example, when deciding which wells to temporarily shut in – an issue every producer is grappling with – data can provide greater surety on well-level profitability.

Getting data in order also positions operators to run scenarios and develop new ways of working that can carry forward and improve future performance, ensuring not only that savings put in place now are sustainable and not just cyclical, but provide a running start for the rebound that is sure to come.

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Turning to refining, are low crude prices a boon for operators in this segment of the value chain, either for merchant refiners or for integrated players seeking to balance the pain felt in their upstream operations?

In theory, yes, but even with tantalizing low input (crude) costs, there are fewer options to place product. So, refiners' initial response has been to adapt, for example bringing minor turnaround and maintenance costs forward and removing discretionary spend and managing contractor headcount.

Refiners are also continuing to review and apply CARES Act support where appropriate. However, we are starting to see that this is not enough. Over the last week or so, we've seen North American refineries being shut down, idled, or have their capacity turned down. Continued stay-at-home orders would likely extend that trend.

In that context, are refiners currently stuck in the middle and how should they think about how to react as restrictions are relaxed?

In some respects, yes, but at the same time, options exist, especially for the more sophisticated and flexible assets, to look at various scenarios and options. We're seeing more sophisticated operators look to a range of data-driven scenarios when making a decision about an individual refinery or, for larger players, about their network as a whole.

It's also important during this time to consider multiple optimistic and pessimistic scenarios, and how frequently these scenarios are being re-evaluated.

Having the agility to react quickly when the market turns could be a differentiator for operators, but data driven analytics and planning is going to be important in ensuring that the actions taken are appropriate in kind and scope.

You mentioned demand has dried up – that, of course, has been driven, in large part, by the slowing rate of consumer visits to gas stations because of shelter-in-place mandates across the US. How is that playing out in the market?

It varies by location and demographic, but we have seen gas station visits down in some areas by 70% to 80% compared with the same time last year. And although gas retailers, many of whom are also convenience retailers, have an opportunity to differentiate through various product offerings, margins are still being squeezed.

On the positive side, with signs of re-opening in many states and, with the wider framework announced by the federal government, we may see demand slowly return in some areas in the coming weeks.

Closing on the more positive note of re-opening the economy, what does the path to recovery look like for fuel retailers and how should they be preparing?

As with other segments, the consistent theme is about becoming more data driven in order to access the next 5% to 10% of value. In fuel retail that is about understanding the consumer, which inherently adds an even greater imperative to gather, analyze and interpret external data and combine it with internal data to inform decisions.

If we believe the new reality will not be a snap-back to where we were, but a more gradual recovery trajectory – possibly never reaching the same level of consumption we saw before, according to some theories – the need to be one step ahead of the competition in identifying where consumption will or will not re-appear, and where it is growing or declining, is going to be more important than ever. Every fuel supplier will be competing for a potentially smaller pool of demand options, and those that are first to sign up the most attractive market niches could be in the lead for a long time.

Olli Valikangas
Principal,
Energy Strategy and M&A
M: 773-255-1890
E: ollivalikangas@kpmg.com

Richard Metzner
Managing Director
Energy Strategy and M&A
M: 312-888-1587
E: richardmetzner@kpmg.com

kpmg.com/socialmedia

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