

# Drilling Down: Managing the dual challenges impacting oil and gas

## The industry confronts dynamic conditions driven by COVID-19 and the collapse of oil prices

In this edition of KPMG Global Energy Institute's Drilling Down, we talk to Regina Mayor, global and U.S. sector head of KPMG Energy, about how oil and gas companies are approaching this unprecedented moment in history.

COVID-19 is dramatically affecting every industry in the United States, and the many efforts to mitigate the spread are disrupting global markets. For oil and gas, COVID-19 is creating a remarkable demand destruction event, given multiplying travel restrictions and quarantines. The negative impact on global growth remains to be seen.

On top of that, the sector is being roiled by a second and simultaneous issue: a burgeoning oversupply of crude oil driven by the battle between OPEC and non-OPEC producers. Together, these events have led to a deeply imbalanced supply/demand scenario and a massive sell-off in oil markets. As of March 20, the price of Brent crude fell more than 60 percent since the beginning of 2020.

### What are U.S. oil and gas companies saying about the impact of COVID-19 on the industry so far?

We are witness to a historic global event. American businesses, officials, and citizens are rising to meet the challenge.

Like company leaders across all industries, oil and gas executives are concerned about keeping their workforce healthy while preparing for the potential of continued demand decline due to business and school shutdowns, stalled economic expansion, and the many other related disruptions to everyday life. Their priorities are safety, business continuity, and job security. We have been working closely with these executives as they try to quickly mitigate risk, manage costs and preserve cash, and test technology capacity for remote work capabilities.

The greater immediate impact on the oil and gas business itself is the collapse of crude oil prices. The timing of the oil price war is unfortunately coinciding with the global rise in COVID-19 cases, leading to significant demand destruction. In fact, global demand projections now indicate negative demand for this year, and some forecasts say demand will fall by 25 percent in the second quarter.<sup>1</sup> Flat or negative demand has only happened three other times in 40 years.<sup>2</sup>

### How is the industry grappling with shock of the oil market collapse?

Global oil and gas leaders are being forced to consider new ways to adapt to the needs and safety of their people, adjust business operations and models, and satisfy evolving

customer demands so that they can ultimately return to stability and, eventually, growth. In the short term, they have to determine what immediate actions need to be taken to survive this turbulent period.

A number of the larger companies have announced spending cuts, dividend reductions, or hiring freezes, and some have started paring down staff. These are bold moves to reassure investors. Many have announced capital spending reductions—any action that can conserve cash in the short term is being considered and announced. They are reviewing their liquidity to get in front of the curve to ensure access to debt, as well as looking at insurance policies to see if business interruption assistance can apply. Still others are creating short-term workforce agreements so they can continue operations with a reduced workforce should a number of employees need time off to recover from illness or care for family.

Meanwhile, those with heavy debt accumulated to pay for drilling projects, particularly smaller operators, have a bumpy road ahead. The oil crash of 2014-2016 is recent history, and we all remember the bankruptcies and workforce reductions. Consolidation is likely, with the larger companies with greater resources coming out on top.

The U.S. federal government is springing to action, offering access to commercial paper loans and directing the Department of Energy to buy crude for the Strategic Petroleum Reserve and "fill it right up to the top."<sup>3</sup> In addition, Texas state authorities are contemplating mandated production output cuts—something we haven't seen in decades.<sup>4</sup>

Through all of this, it's important to keep in mind that the world still relies heavily on fossil fuels. The demand will still be there once COVID-19 is more contained; the industry will continue. Once we see supply chains operate more effectively, and quarantine and travel restrictions lifted, demand will begin to increase and buoy the oil price along with it. Individual companies must be healthy enough to operate when the supply side of the equation returns to some normalcy.

<sup>1</sup> Source: Eurasia Group, March 2020.

<sup>2</sup> Source: Bloomberg: "Coronavirus Adds New Peril Ahead of Shale Borrower Bank Meetings." March 4, 2020.

<sup>3</sup> Source: Reuters. "U.S. to fill strategic oil reserve 'to the top,' Trump says" March 13, 2020.

<sup>4</sup> Source: The Wall Street Journal. "U.S. Considers Intervention in Saudi-Russia Oil Standoff." March 20, 2020.

## **In addition to straightforward cost-cutting, what are oil and gas companies doing to protect their business right now, and what should they be thinking about?**

Overall, COVID-19 has every executive taking a hard look at their corporate risk and resilience, determining what's holding up, and considering actions to take to correct any failures. This isn't the last low-probability/high-impact event.

In addition to immediate crisis management, oil and gas companies are looking to better integrate risk into strategic planning, rather than treating risk management as a separate effort. They also are reevaluating their footprint and partnerships, considering where there might be weaknesses exposed by high-impact events like this.

Few business functions have been hit harder by COVID-19 than supply chains. How companies are dealing with the impact can be divided into short- and long-term activities. Capital project supply chains need to be re-evaluated to see if critical equipment from Asia will still arrive on time. And fuels, lubricants, and specialty chemicals supply chains are all being rerouted (or stored) as demand has slowed and shipping routes have been disrupted.

Additionally, we have seen more energy companies move toward zero-based budgeting in recent years to help manage costs in a fast-paced business environment. This method can better allow companies to allocate resources based on efficiency, necessity, and value as priorities shift, compared to traditional budgeting that allocates resources for the coming year based on historical spending. In tough conditions like we are experiencing today, zero-based budgeting can help stretch limited resources to achieve the greatest returns. Now is the time to start from the ground up to resize the business, with crude prices in the \$20s.

Finally, it's increasingly important to ramp up cybersecurity protections as more people work remotely, and company systems are more vulnerable. With facilities being operated with

fewer on-site personnel, operations technologies may be more prone to attack.

## **What are leading oil and gas companies thinking about in preparation for the recovery period?**

The human and economic stress of managing the dual challenges facing the oil and gas industry is significant, and the length and depth of that stress is unpredictable. But everything that companies are doing right now to address urgent issues are the same things they must continue to do to prepare for future successes.

As supply chains begin to move briskly again and travel restrictions lift, demand will return. That will be a turning point and a shift to proactive planning. Leaders will begin to stress test internal operations, examine the agility of supply chains, and upgrade technology so that when another unforeseen event arises, organizations will be even more resilient than they are today.

Looking further out, as historical demand patterns change, the industry simply has to continue to adapt and change in anticipation of trends and disruptions beyond the current global health and commodity price issues.

The work oil and gas companies have done to date to implement more digital technologies and plan for declining demand from the energy transition is a large part of this preparation. After all, demand has been growing for renewable sources of energy. Today's oil and gas company may look completely different tomorrow, with portfolios further expanding into renewable assets, decarbonization technologies, electrified transportation, and more data-driven consumer products and services.

The energy industry has proven its resilience time and again. I am inspired by our efforts to work together to help ensure the industry makes a strong recovery from the current challenges and continues to expand and secure energy access for people all around the world.

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