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T. Pilenko "It will take two to three years for the oil and gas industry to recover"

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Thierry Pilenko, one of the foremost experts in the oil and gas industry, chairman of C&S Partners advisory board, delivers his keys to understand the actual oil crisis, the damage Covid-19 has done to the industry and reactions to take to minimize the impact.

Leaders League. This is far from the first crisis to hit your industry. What's different this time round?

Thierry Pilenko. In my four decades in the industry I have indeed seen some crises…1986, 1991, 1998, 2009, 2014 and 2019… the overlap with the latter meaning we are in a crisis within a crisis. Now, as in the past, something happens to trigger a crisis. In this case it was the decision by Saudi Arabia and Russia to increase production, which lead to a dramatic drop in oil prices – by 25% in one day. However this crisis has a different dimension to others, namely the sharp fall in demand due to the coronavirus. While this is an unprecedented one-two punch, it gets worse. There is a third, less talked about, aspect to the crisis, which is the impact on the industry's support services sector, which was he already struggling before February's crisis.
We are in uncharted waters, with overproduction of all types of energy, the shutdown of ancillary industries, the downward pressure on prices. It's shaping up to be the perfect storm.

How will the industry react?

There are three issues to tackle; the price issue, the cost-cutting issue and the transformation issue. Since the crisis of 2014, oil and gas companies have been very cautious about making major investments. They learnt a lot from that crisis, notably how to make fast decisions on putting capital expenditure and operational expenditure on standby. Rulings on projects are now often handed down on the same day, in some cases even for major projects, a speed which was unheard of back in 2014! This capacity to take swift action has filtered down from international to national companies in the intervening years. What stands out, however, is that Middle Eastern companies favor reducing prices over capacity.

When it comes to support services, the crisis has led to a knee-jerk reaction to reduce costs. Contrary to 2014, the sector was already in a bad way, with prices falling over the past five years and therefore reduced margins and room to manoeuvre. It is imperative, therefore that we continue in this regard in order to further reduce costs. The first casualties of this are, unfortunately the workers. It is estimated that there are five million people working in industries related to oil and gas. Personally, I think that number is significantly higher, given the difficulty of getting accurate numbers from Russia and China. I would say we are looking at around 20% of those losing their jobs.

In the past, we tried to find what I would call a happy medium with customers, but the reality was that, very quickly we saw overcapacity, which saw an end to this and a return to the law of the market.

Another pitfall to avoid: in cutting costs, companies often have the tendency to recentralize decision making and take back more control over operations. In these multinational companies, the consequences of this are disempowerment and reduced motivation among staff-members interacting with clients. The reflex is human, but it is counterproductive. Maintaining the morale of teams on the ground is vital. The only exception I would say concerns marketing and sales strategy. When redeploying capital, it is important to have a global vision across all regions.

Generally speaking, cost reductions only work when they equate to selling off assets or reducing certain activities, making a multitude of smaller cuts in not effective.

In the support services industry, we often see companies engaged in multiple activities with a spread of headquarters. In this case it would be better to decide to halt production of one factory or in one country that has limited potential.

Material capacity in and of itself is not a differentiating factor. What the customer is looking for is the complete package, something which allows them to reduce costs. You need to offer them integrated solutions. But to decide on what they should be, we can't only take decisions at the highest levels, there needs to be a certain level of consensus. CEOs have a tendency to sit in their ivory towers, but it is transparency and teamwork make the difference between success and failure at times like these.

How will the current crisis impact fracking in the US?

The strategy of Russia and Saudi Arabia is to flood the market with cheap petrol. It's worth remembering that the Saudis are capable of sustaining production at under five dollars a barrel, and the Russians at a little over that. To break even, and equivalent amount of shale gas needs to sell at between $30 to $35.

When crude sells for $20 to $30 per barrel, shale is a viable alternative. We saw this back in 2014. However I foresee a similar situation to the tug of war of 2014, when shale gas production grew throughout 2015 until we reached inertia in the market but also among the majority of smaller players. The year after, when subsidies stopped, production was forced to decrease.

That said, the flexibility in the market is remarkable: there has been an incredible injection of ingenuity and innovation into the shale gas industry between 2014 and present day, which has seen prospecting an production costs fall. The potential of shale gas is still there and remains to be explored, I believe. We have only touched upon 10% of available stores and, especially with the options AI afford the industry, the future for shale could be big. However, only the biggest and best resourced fracking companies will be able to weather the current storm. Drilling wells has been relatively straightforward to date, but we will need to see what we can do with existing wells. I would not be surprised to see the super-majors, principally in America, make their move in the months to come.

How can that happen when prices are so high?

The oil and gas industry will take two to three years to recover. In the short term, it will be difficult to strike a substantial enough deal between Saudi Arabia and Russia, even though it's true they have surprised us in the past. Hope remains that at a certain point they will want to shore up prices by cutting production. Only this step, based on an agreed increase in production only when the world comes out of the health crisis and the economy starts to get back on its feet, will see prices start to rise.
In the short to medium term, we will see oil storage facilities reach capacity by mid summer and, given that the petrol tankers are being rented at extremely high prices, these will be used as de facto storage facilities. We will then need to use up this excess oil supply, because the difference in supply and demand at the moment is between 10 and 25 million barrels per day. There will therefore be considerable short-term pressure on the price of a barrel of crude. One thing is for certain, there will be no miracle solution.

Can't the US do anything about the situation?

The ability of Washington to exert influence on the major oil producing nations is overestimated. Unlike those nations mentioned above, the US does not have a centralized oil industry dominated by large state-run companies, so it is even difficult for the US administration to influence American companies, who act above all according to market forces. However, even if a lot of workers from the oil and gas industry find themselves in the unemployment line, this is a situation the industry is used to facing every seven years or so.

To avoid this cycle of volatility and stability from repeating, does it not behove companies in the oil and gas sector to revisit their strategies, to not be dependent on just one sector?

That's a very good question, but I have no quick answer to it. If the crisis continues for an extended period of time, we might well see conglomerates reform. But up until very recently the prevailing appetite among investors, in particular those from North America, was for extremely specialized companies.
In any case, we are definitely going to be more conservative when it comes to debt, cash-flow and balance sheets. It is clear that we, as an industry, did not sufficiently learn the lessons of previous crashes, which showed that the most

careful and most integrated of companies are the ones which can weather a big crisis. This year has been a huge wake up call to the industry.

What are the best ways to manage this crisis to your mind?

The first thing I would say in that it is important to have an entirely integrated offering. It is equally important to push for the most flexibility and agility. The third ingredient, and this may seem counter intuitive, is to know how to cut the number of workers without losing those critical to getting us out of this crisis: this is the great paradox of the support services sector. The core must be maintained.

I would also like to press home another point. The peculiarity of this crisis is that it is not of our own making. Normally, in our industry security is of the utmost import and managers must know how to assume the burden. But here we have a virus that respects no hierarchy - the same people that are used to assuming responsibility in a normal emergency, may be at a loss to respond to this one. Leadership does not always have to come from the top, empathy for our fellow man is fundamental in this current crisis. We need to foster the development of soft-skills going forward.

(translated from French article of Décideurs Magazine)