

Governing Energy

Optimism

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Every January the world begins anew and we all hope for a better year than the previous one. Sometimes that works out and sometimes we fall short of expectations, and resolutions.

The oil and gas industry enters the new year with a feeling of optimism. It seems that the worst of the “depression” is behind us and expectations of a much stronger commodity price point abound. However, we must be careful with our projections as the economic fundamentals have not necessarily changed.

OPEC has announced production cutbacks, thus supporting a higher oil price. Perhaps this will be the case. However, there forces at work against this process.ⁱ

Twelve months from now we will all know whether the trading range for this commodity met expectations or not. Regardless, executives must still drive their business.

The Weighted Average Cost of Capital (WACC) is defined as the proportional or weighted calculation of the firm’s total source of capital—debt and equity.ⁱⁱ In order to add value to shareholders, firms must generate greater returns than the WACC. This is different from accounting profit or those reported on the quarterly Income Statements.ⁱⁱⁱ

A recent (based on 2014 data) industry wide benchmark indicated that most oil and gas operators did not generate a positive return on their Cost of Capital during the so called boom times.^{iv} One hypothesis is that if the returns were negative during those very good times, it is likely that they will not be positive this year either.

Renewed optimism must be enabled with new approaches to the business. In this blog, we have reported the role of technologies driving costs down and generating economic profit at much lower break even points.

It is important that organizations not let their guard down if the market remains stronger. The natural tendency to “get back to normal” should be resisted because the old normal was not that good either.

With a focus on Operational Excellence, firms can unlock trapped value in their Balance Sheets.^v It follows that strengthening the Balance Sheet and thus increasing retained earnings (component of equity value), WACC is driven lower.^{vi}

Most of us are optimistic by nature and this time of year we look forward to the New Year. Temper that natural tendency with changes to your business model that will enable your firm to capture economic value going forward.

How Will Your Organization Translate Optimism to the Bottom Line?

About the Author

Dr. [Scott M. Shemwell](#) has over 30 years technical and executive management experience primarily in the energy sector. He is the author of six books and has written extensively about the field of operations. Shemwell is the Managing Director of The Rapid Response Institute, a firm that focuses on providing its customers with solutions enabling Operational Excellence and regulatory compliance management. He has studied cultural interactions for more than 30 years—his dissertation; *Cross Cultural Negotiations Between Japanese and American Businessmen: A Systems Analysis (Exploratory Study)* is an early peer reviewed manuscript addressing the systemic structure of social relationships.

End Notes

ⁱ <http://oilprice.com/Energy/Crude-Oil/OPECs-Announced-Production-Cuts-Are-A-Big-Deal.html>

ⁱⁱ <http://www.investopedia.com/terms/w/wacc.asp>

ⁱⁱⁱ <http://www.investinganswers.com/financial-dictionary/financial-statement-analysis/economic-value-added-eva-2925>

^{iv} Webinar. (2017, January 19). Make Oil & Gas Great Again Series: Does Your Company Return Its Cost of Capital? <https://attendee.gotowebinar.com/register/3843788576843273729>

^v <http://www.pennenergy.com/articles/blogs/governing-energy/2016/06/what-do-we-do-now.html>

^{vi} http://www.cengage.com/finance/book_content/0324319835_brigham/web_appendices/pdfs/10A.pdf