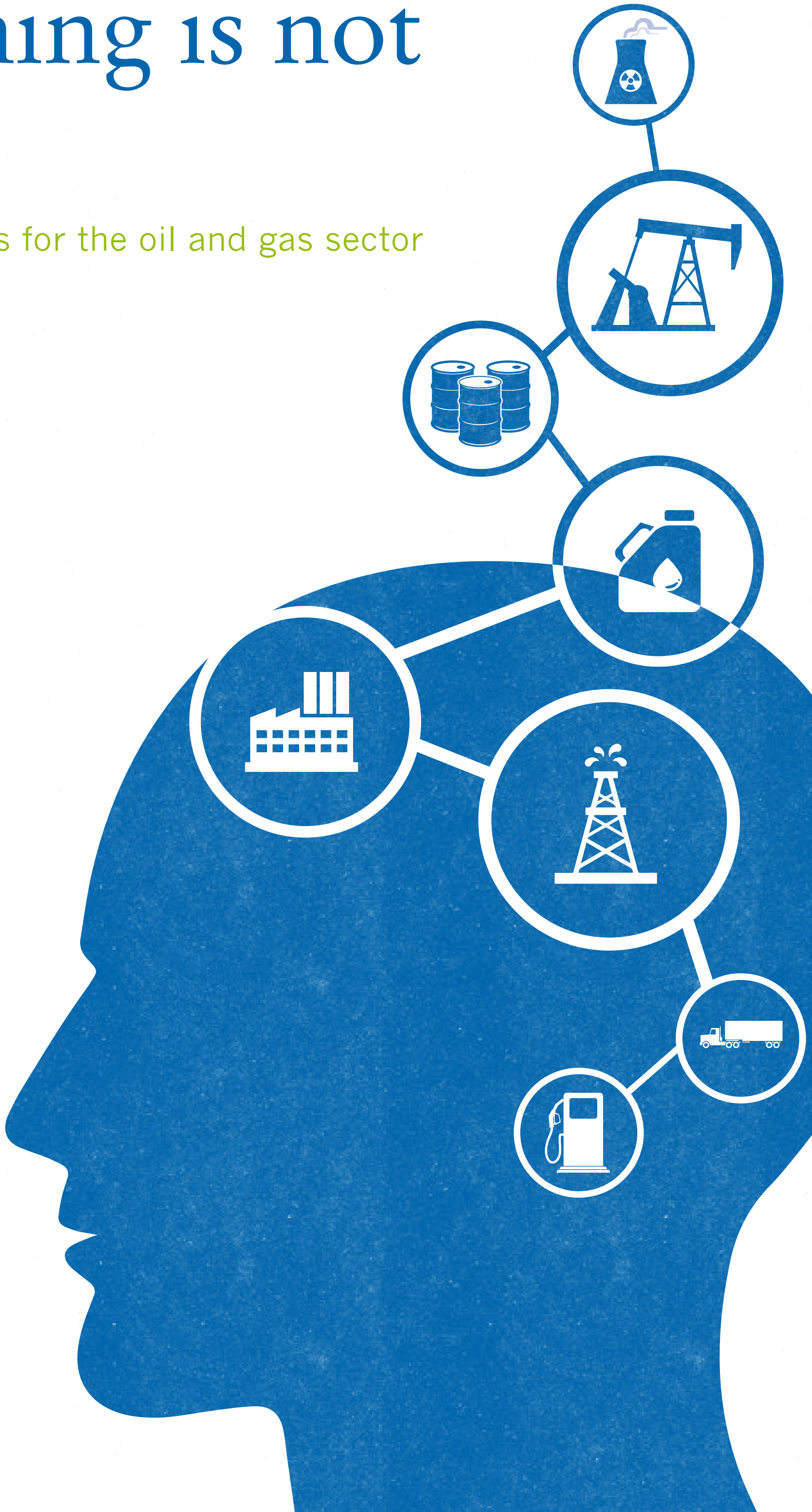
Doing nothing is not an option

Current and future perspectives for the oil and gas sector



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Industry overview

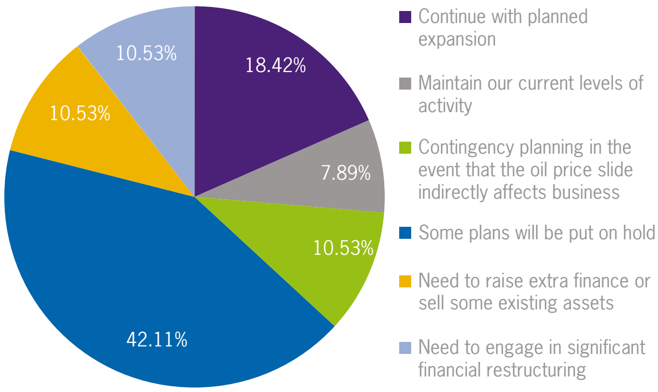
The oil and gas industry is continuing to experience significant challenges as a consequence of reduced oil prices. The result of which means changes within the sector are inevitable. Grant Thornton's oil and gas team conducted a survey where we sought the opinions of senior executives within the sector on what the current market environment meant for them and their company. In the following report we share these results and consider the future direction of the industry.

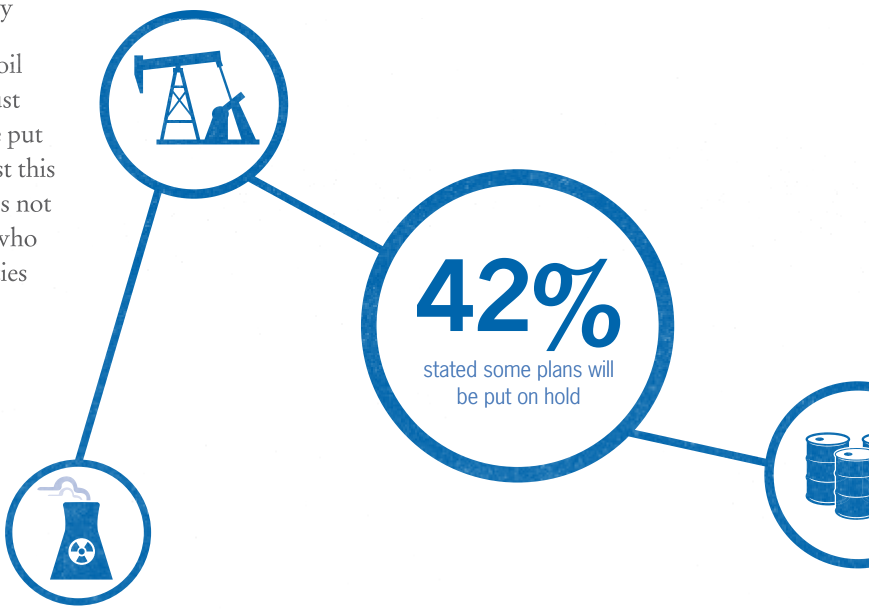
The key messages from our recent survey and our discussions in the marketplace are:

- disagreement on direction and level of future prices
- volatility is likely to remain for several years
- contract renegotiation and price cutting will continue
- drilling and seismic activities declining significantly
- reserve based lending more difficult to access
- new investors to sector likely
- consolidation, restructuring and in some cases insolvency inevitable
- cash is king - low prices create significant opportunity

Our survey opened by asking how a prolonged drop in oil price would impact the respondent's business in 2015. Just over 42% stated that some of their strategic plans will be put on hold. Global leader Linda Beal commented that whilst this is understandable in the very short term, doing nothing is not an option nor is it sustainable in the long term. Groups who move quickly to address challenges and seize opportunities will be the likely winners.

Impact on business of prolonged drop in oil price in 2015?





Predicting the unpredictable

Predicting future oil price is always difficult but perhaps even more so in the current environment. What was clear from our survey was that our respondents disagreed about not only the level but also the direction of longer term pricing. Just over half of our respondents clearly see the low prices as a short term feature that will be followed by an increase as supply is removed from the market.

What our survey also showed was that existing producers were not as optimistic as early stage respondents when assessing where the oil price would be at the end of 2015. 63% of early stage respondents believe that the oil price will be between $55 – 65 per barrel as opposed to 46% of existing producers.

Looking further into the future to the end of 2016 85% of early stage company respondents believed the oil price will rebound to between $56-100 per barrel whereas 66% of existing producers thought this

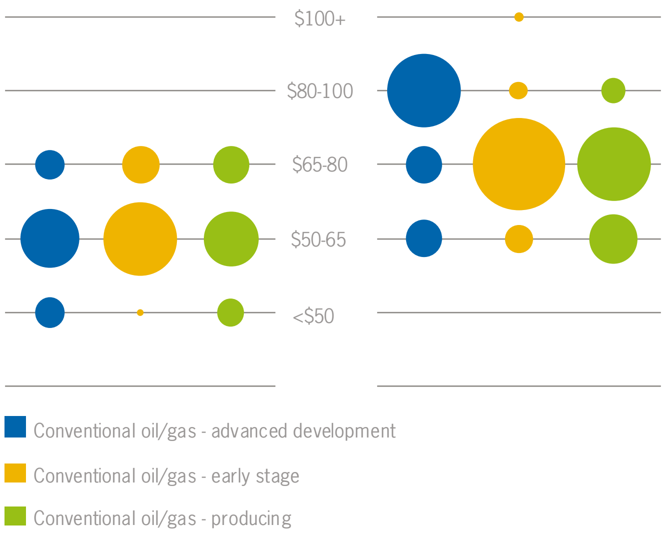
This may reflect natural optimism on the part of explorers but it is the producers who will generally be closest to the markets.

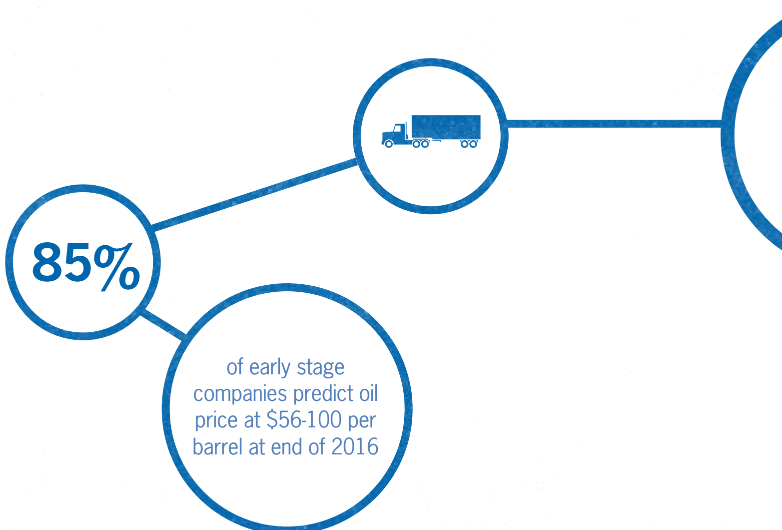
What is driving the pricing?

We know that the answer in broad terms is supply and demand. However, the oil price dropped by 50% whilst, as one of the respondents to our survey stated, the demand for oil has not dropped by this amount. The Bank for International Settlements stated that oil production has been close to prior expectations, whilst demand has only been a little weaker than forecast. Therefore the huge drop in oil price appears to have been caused at least in part by trading and financial flows, rather than purely by changes in supply and demand. The World Bank as of January 2015 predicted an average price for this year of US$53 and US$57 for 2016, indicating a period of continuing low prices. It appears the recent years of a high, relatively stable low volatility price have for the time being gone.

Whilst some still predict a strong rebound, the point is that this cannot be assumed and companies have to therefore address the potential of long term low prices.

Predicted oil price 31 Dec 2015 | **Predicted oil price 31 Dec 2016**





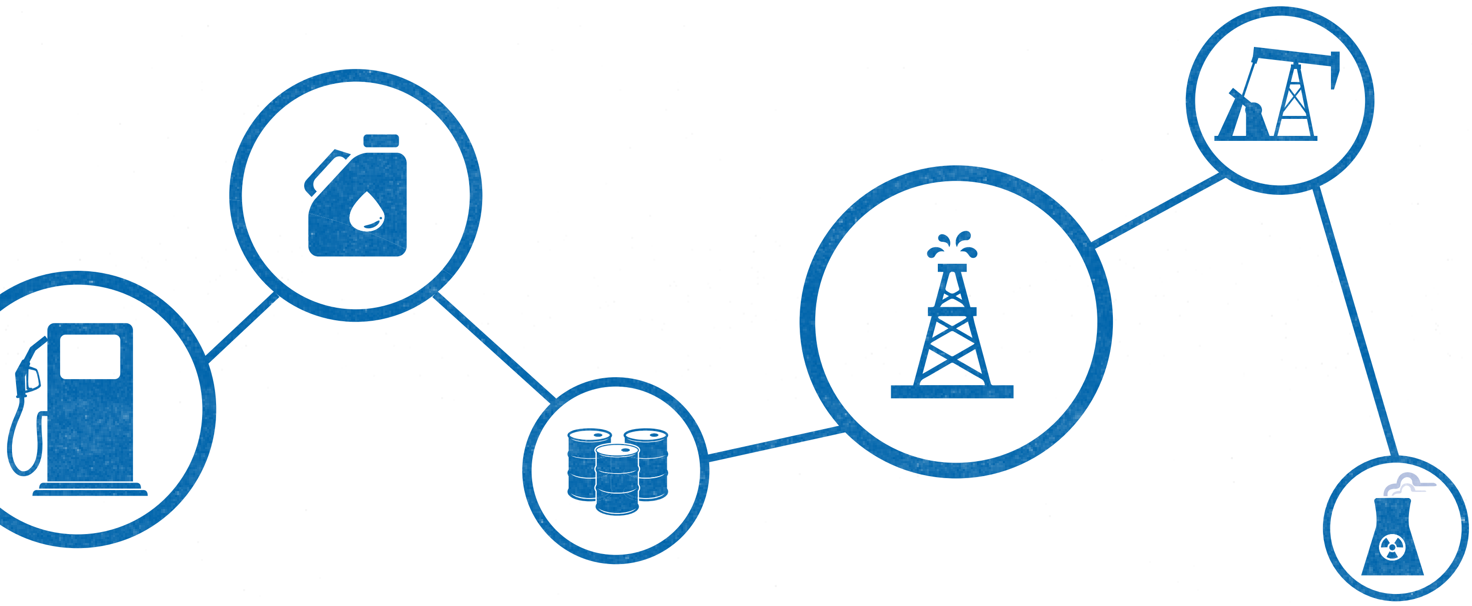
A future perspective

We all know that the future is unpredictable. If we had conducted this survey last year, who of our respondents would have predicted an oil price of below $60 a barrel. Predicting future trends in the industry is not an exact science. A key factor with regard to pricing moving forward will be around the storing of oil, which is the physical equivalent of financial derivatives. This will have a direct impact on supply and demand and ties into trading.

Where significantly higher prices are expected in the near future, it can make sense to buy early, store and then sell when prices are higher. The greater the storage capacity available and the lower the cost, the more likely it is that storage is used, with consequent smoothing impacts on pricing. Even though China and India are using low prices to build strategic reserves, there is limited further storage capacity available though so that smoothing effect is coming to an end.

Grant Thornton's US oil and gas leader Kevin Schroeder commented that in the US the downturn in oil price has resulted in the oil and gas industry planning for stagnant oil pricing over several years. US producers significantly reduced their capital budgets for 2015 which means less wells will be drilled and less producing wells will be worked over to preserve liquidity. Indeed this extends to US shale producers who will continue to drill but will focus on drilling optimal development wells. In many cases all exploratory wells have been removed from drilling schedules and capital budgets due to the continuing low oil price.

In theory, with demand due to rise, the price should too given that supply should, if anything, reduce in the short term. Unfortunately the impact of trading and herd behaviour means that this cannot be guaranteed.



Impact on supply chain

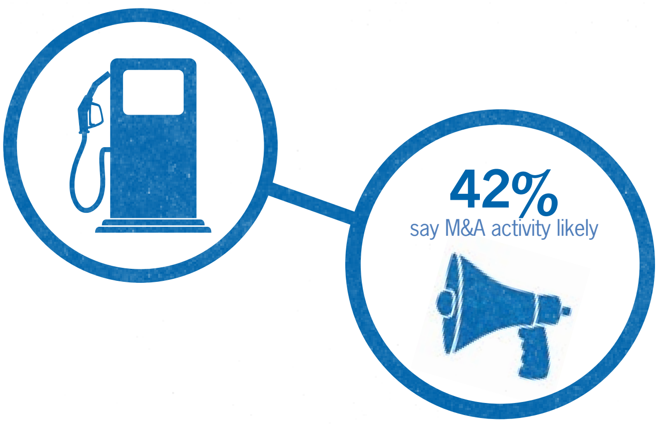
Immediate Issues

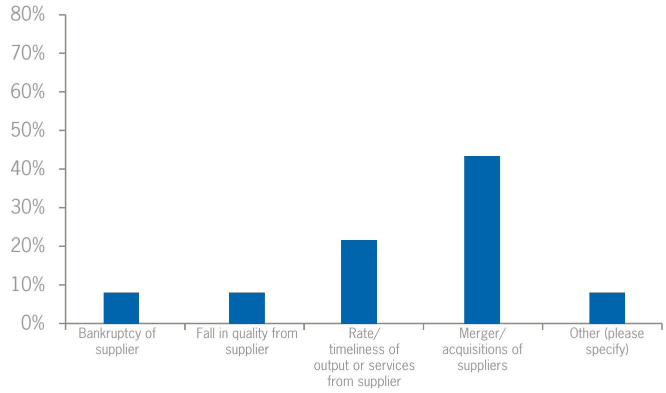
There is already clear evidence of the supply chain suffering in various ways as a result of the price reductions. Some companies are imposing unilateral cuts on suppliers across the board, demanding a reduction whatever the contract says.

We asked our respondents if they were anticipating issues in their supply chain as a result of current market conditions. 42% of respondents believe that M&A activity within the supply chain is likely, whilst just over a fifth believed that there would be issues within their supply chain.

The pressure being felt across the supply chain as a result of the lower oil price impacts on the cost of rigs and seismic vessels etc. which are all dropping significantly. A recent piece of analysis by WoodMackenzie[1] suggests that the daily rate for a high spec horizontal rig will drop by 30% in 2015 hitting contractors profitability. In the US the active drilling rig count has declined for fourteen straight weeks to the lowest count in 5 years, with active oil rigs down over 700 rigs since the previous high of just over 1,600 in October 2014.

Furthermore, reduced drilling count will result in a decline in US oil production beginning around the third quarter of 2015. Without new wells coming on line and with decreased well workover activity, natural decline in production will occur.





Even if the oil price rebounds fully, it is unlikely that supplier pricing can simply revert to where it was. This means that throughout the supply chain a far greater focus on operational efficiency can be expected and a greater premium on flexibility so possibly more hiring of equipment rather than purchasing it.

Contract Breach and Contract Renegotiation

Whether as a result of company failures, lack of finance or seizing an opportunity, it is clear that contract renegotiations are already underway. Many companies are asking directly for price reductions, whether stated in the contract or not. Whenever the economics of a contract move significantly from where the wider marketplace is, there is greater incentive to break the contract. so that continues to be the case. The other impact, which will take longer to be felt, is whether there are increased terminations by governments under Production Sharing Agreements for failure to meet Minimum Work Programmes. Whilst in the short term that may be less likely due to the difficulty of finding a replacement (something may be better than nothing) in the longer term it could be worthwhile for a government.

[1] Source WoodMackenzie Industry Views 19 February 2015. http://public.woodmac.com/public/views/us-rig-count?filter_sector=1

Different models of contracting

One of the recommendations of the Wood Report[2] for the North Sea was greater sharing of infrastructure. Whilst it clearly does apply in this jurisdiction, the question has to be whether different methods of working should be applied not only there but in other developments eg further development of Mexican fields. This will need some working through but could itself lead to new opportunities for those companies willing to adopt new business models.

Consolidation of suppliers

The mix of lower income and greater difficulty in raising finance is likely to lead to an increasing number of companies becoming insolvent or being required to restructure their operations. Some of this is already happening. Our survey found a relatively low number of 8% expecting bankruptcy of their suppliers but an additional 42% expecting consolidation amongst suppliers. What we can see is that for oil field services companies the short term picture may not be too bad as existing work continues to be completed, but the crunch could come in the second half of 2015. If E&P companies are still not committing to further field work due to factors including increased price volatility, lower prices and a greater difficulty in raising finance, a squeeze on the overall supply chain is inevitable. Doing nothing now is not an option.

Such effects are not limited to the oil industry directly. Banks, construction companies, hotels, property developments restaurants, airlines and car dealerships are just some of those broader sectors feeling the impact. Hotel occupancy and new car sales in Aberdeen are down as the local economy feels the impact.

Future perspectives

With the prospect of contracts not reverting back regardless of a bounce back in oil price and on-going M&A activity within the supply chain, companies need to be agile to succeed. Executives will need to keep all options open with a more flexible workforce that can readily scale up or down and is even more able to move internationally than has been the case until now. This agility of being able to move workforce to where the opportunities are in the world will be a key success driver and will result in continued consolidation within the market.

[2] Source http://www.woodreview.co.uk/documents/UKCS%20Maximising%20Recovery%20Review%20FINAL%2072pp%20locked.pdf

Access to capital

Greater Difficulty Raising Finance

A number of investors in the sector, whether debt or equity, have had a sharp reminder that oil prices can indeed be very volatile. Many, even those that have been in the industry for a long time, had perhaps forgotten that. Whilst there are new structures available to raise finance such as royalty based lending, there is clear evidence of increased difficulty of sourcing finance in the market. This has led to increased debate about the price scenario to adopt for company valuation. Raising capital is not just an issue for E&P companies but also oil field service companies, equipment providers and those reliant on the sector who are all finding it more difficult to raise capital.

Producers have also been active in managing their debt positions, most remembering challenges in the last downturn in 2008. Many companies will face challenges with upcoming borrowing base redeterminations of their credit facilities, which are often determined twice a year based on the lender's estimate of a borrower's oil and gas reserves values. This means that companies that did have a healthy lending margin may suddenly find themselves in a very difficult position and banks face a greater risk exposure. The stronger companies have better positioned their debt structure to be free of certain covenants or have not borrowed to levels that could require principal payments from a downward revision of a borrowing base. Many companies have also been renegotiating terms of their debt with banks to avoid related issues.

This does not mean that all reserve backed lending has ceased. Some will continue, for example, Eland Oil and Gas plc raised US$75m with Standard Chartered in January 2015. What it does mean though is that all of these positions will be more closely managed, that there will be a number of defaults and that this can be expected to be less available as a source of financing. This is what will drive some consolidation, restructuring or even insolvency.

New Investors

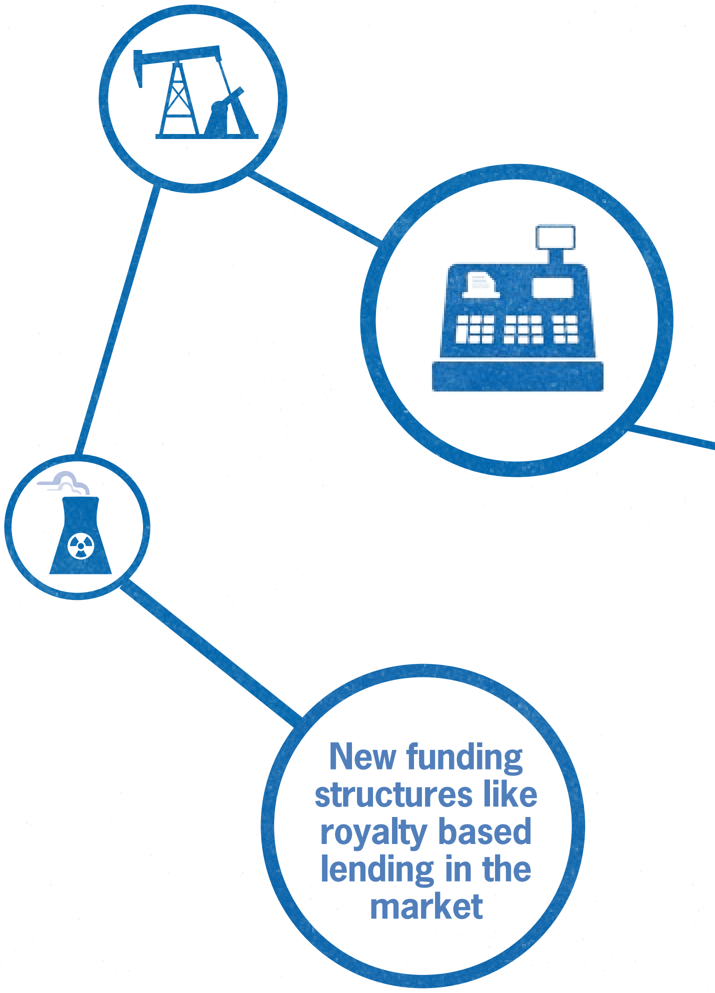
We are seeing evidence of a number of different trends that provide opportunities going forward. Particular themes are:

1. A by-product of the differences in pricing is that some investors such as private equity or sovereign wealth funds, who were previously dissuaded from investing in the sector because of perceived high prices are now stepping forward seeking opportunities. The reduction in prices coupled with the lowering value of businesses means there are therefore deals to be done. The question is whether the willingness will be there for sellers to accept these lower prices. Experience from the Spanish recession suggests that this could take some time, as it was only after a prolonged period that sellers were willing to accept the lower prices required to complete transactions.
2. Continuing investment from China in particular is prevalent, but increasingly from other countries such as Korea and Nigeria.

Future perspectives – cash is king

For those companies that have access to cash there is great opportunity to get more for their money in the current climate. We are seeing an uptake of potential transactions in the market – 42% of our respondents expect further M&A across the full oil and gas supply chain. We see consolidation as a good thing. The sector needs it to add flexibility and diversity to companies current portfolios.

For those companies that can demonstrate a strong investment case there are new funding structures such as royalty based lending in the market to support the raising of finance. This has the added benefit of securing finance for the group but only having to share the upside in one field for example.

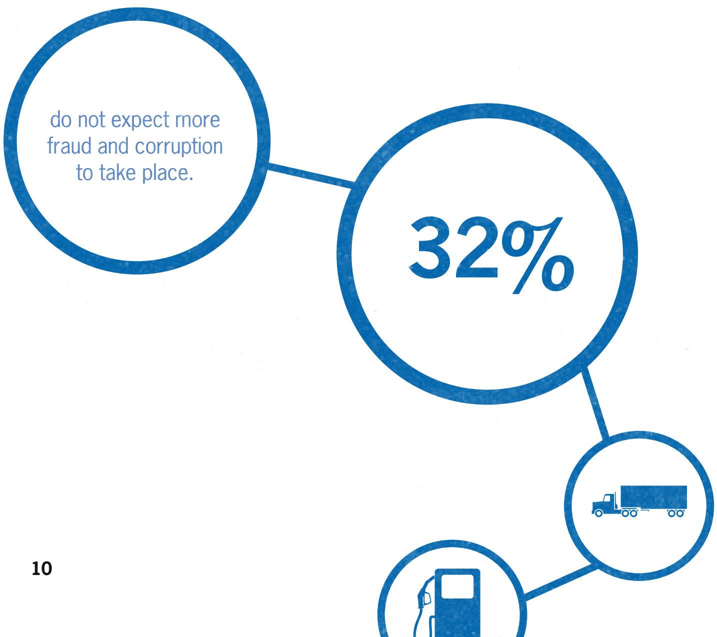


Regulatory

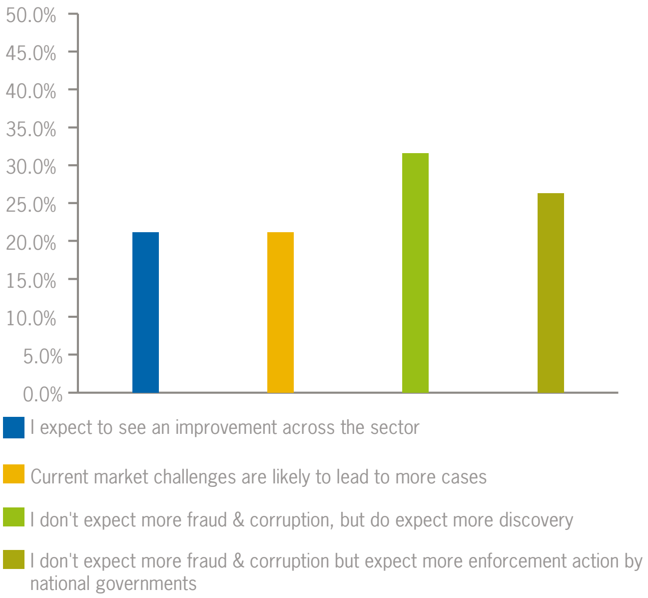
Greater Difficulty Raising Finance

The short term pricing issues in the sector can tempt people to overlook other issues such as bribery and corruption and ensuring that the right corporate governance is in place. The complexity of contractual relationships with suppliers, capital partners and national governments means the sector comes under specific scrutiny in this area. Some of the most significant penalties incurred for non-compliance have been handed out by regulators to companies within the oil and gas sector. We asked our respondents what their views were with regard to fraud and corruption, particularly as the industry continues to operate in geographical areas where these risks are prevalent.

32% of respondents did not expect more fraud and corruption but did expect more discovery to take place. Over a quarter of our respondents expect more enforcement and action by national governments. With new wide ranging legislation in some countries plus greater enforcement of existing legislation such as the UK Bribery Act, companies in the sector will need to apply thorough country-by-country reviews and risk assessments of their anti-bribery and corruption systems and controls.



The oil and gas industry continues to operate in geographic areas at risk from fraud and corruption. What is your view with regards this issue?



As the cases of companies big and small like Petrobras and Afren show, any issues around fraud have a dramatic market effect. Petrobras has had its credit rating slashed to junk status by Moodys, whilst Afren lost around 90% of its share value since March 2014.

It is wrong to assume that going forward the pursuit of corruption will be mostly driven by the US and EU, as it often has in the past. These days there is growing pressure from governments around the world such as a crackdown in China, a new law in Brazil (and doubtless more pressure as a result of Petrobras). We expect this trend to continue adding further complexity and regulatory burden on the sector.

Decommissioning

One item in the mix that will be new going forward is an increasing level of decommissioning of oilfields.

Historically, this has been repeatedly shown at the outer edge of projections but now, with low prices, more fields are moving to decommissioning. A key issue for the North Sea is the domino effect, where if hub fields close the knock-on impact on other fields that depend on some of the related infrastructure can be significant.

Future perspectives

The OECD highlighted in its December 2014 OECD Foreign Bribery Report that the extractives sector was the single biggest sector for reported bribery cases. The continued continued push for greater transparency and cases such as Petrobras and Afren will likely contribute to further enforcement in this area. Colin Johnson, energy expert in our forensic services team says that even though this may seem like unnecessary spend in a downturn, companies ignore it at their peril, as the woes of Petrobras demonstrate.

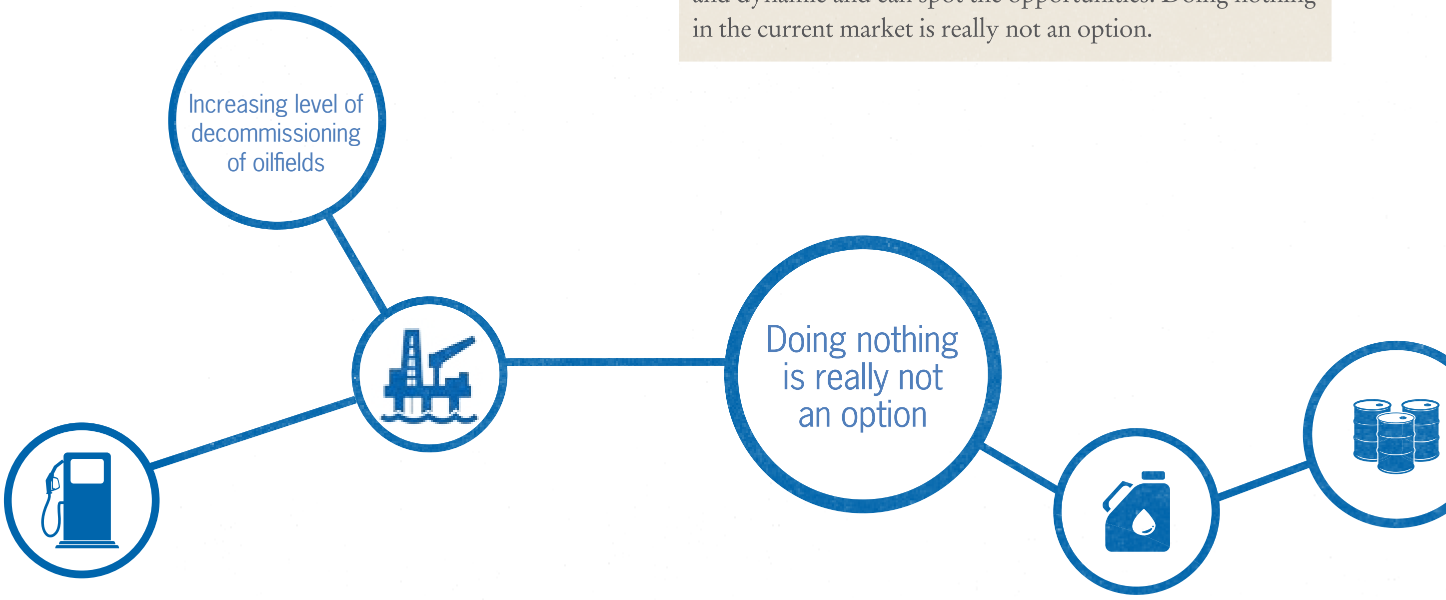
Conclusion

A key success to the growth of the oil and gas sector will be consolidation. This will allow for more flexibility and diverse portfolios.

In the US, many expect the oil and gas industry will emerge even stronger, considering the availability of investment capital – largely private equity driven, and the robustness and strong integration of the producers, service companies, midstream companies, and others serving the American energy industry.

While technology and efficiency gains have been rapid in the shale market over recent years, which has led to reduced drilling time, reduced costs to drill, frack and complete wells, further efficiency gains will result from this downturn. The US producers, together with companies from the other energy sectors, are working together to gain further efficiencies in the exploration and development of the shale plays.

So what does the future hold for the oil and gas sector? The winners will be the ones with access to cash, that are agile and dynamic and can spot the opportunities. Doing nothing in the current market is really not an option.



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