What is the Future for oil and gas?

Oil and Gas Technology gathered together six experts from the business sector to discuss how the current low oil prices are affecting the oil and gas sector

With the introductions made, coffee and pastries served it's time to get down to business

Oil & Gas Technology: Now that we can see that low oil prices are not a short-term blip, what are the main effects on the business of oil and gas companies?

Janet Duff: Across the industry, companies have carried out a fundamental review of their business. They have undertaken a strategic assessment of their asset portfolio assessing whether it meets their strategic objectives, and is adequately balanced to meet the new sub-USD50 world. This balance can include making sure the asset portfolio contains the right mix of development and producing assets, the right spread geographically, and the right blend of co-venturers to share in the risk and to provide a return to shareholders.

All functions have come under pressure to find cost savings. Some projects have been cancelled or mothballed, headcounts reduced.

Paul Exley: Oil and gas companies are coming to terms with the lower for longer outlook for oil prices. Cost cutting will go deeper and companies will increase their focus on those assets and projects where they can add most value. Operational efficiency and securing finance for working capital and growth capital will be key. M&A activity is expected to rise as the gap between buyers and sellers price expectations narrows and reality bites.

Alan Free: Cost reduction imperatives are getting most of the spotlight across upstream, midstream and downstream services. Projects are getting pulled back, reshaped or cancelled, while surviving initiatives face demands for higher payback hurdles as bets are placed for 2017. M&A activity is rising, as companies strategically re-evaluate lines of business and chase inorganic growth. Finally, everyone is taking a deeper look at maximising production throughput and avoiding any unplanned downtime events, such as the recent Colonial Pipeline failure or the recent MOTIVA refinery fire.

Michael Burns: Companies will need to be leaner and keener – keeping close watch on costs, post already invoked cost cutting, and being dynamic in responding to new opportunities that arise in the market. First mover advantage in emerging markets will be more important than ever for example.

Shay Kuperman: We have many clients seeking to strengthen their asset portfolio. We have seen many oil and gas companies selling off non-core asset positions, to focus on basins where they can remain profitable in this low-price environment. We have also seen a focus on acquiring producing properties in several transactions, in order to avoid the capital spend requirements to drill out undeveloped acreage.

Oil & Gas Technology: Is this change just short-term repositioning, or does it herald a new paradigm for the sector?

Shay Kuperman: Of course, this is difficult to tell. However, the prevailing mood seems to be the industry may have done too good of a job in identifying additional conventional and unconventional producing formations during the past several years, and therefore it will be difficult for prices to rise much because there is production identified that is ready to come online whenever prices rise, which would prevent any significant price increase.

Meet the experts

Michael Burns, partner in corporate practice at Ashurst

Michael specialises in mergers and acquisitions, joint ventures and major project development with a focus on the energy sector (in particular oil and gas and power).

His clients include multinational corporates, financial institutions, governments and individuals. In the last 12 months, Michael has advised on significant mergers and acquisitions including several disposals in the North Sea, an acquisition in Egypt and an oil storage acquisition and joint venture.

Janet Duff, senior associate in Hogan Lovells' London office

Janet is a member of the firm's international Energy Industry Group. Janet's main experience is in mergers and acquisitions, upstream oil and gas agreements, farm-outs, governmental and inter-governmental agreements, and other commercial arrangements in the energy and natural resources sectors. She spent six months on secondment at ExxonMobil, where she focused on corporate matters, upstream commercial matters, offshore production licensing, and procurement regulations.

Archie Fallon, partner in King & Spalding's Houston office

Archie represents public and private energy companies, private equity funds and financial institutions in mergers and acquisitions, joint ventures, corporate finance transactions, financial restructurings and governance matters. He has significant experience advising clients in the structuring, finance and development of complex oil & gas, LNG, power and renewable, shipping and energy projects in the U.S. and internationally.

Paul Exley, corporate partner in Baker Botts' London office

As an expert in international and domestic transactional work, Paul has a particular focus on cross-border M&A in the energy sector. Clients he has acted for include governments, oil majors, state-owned enterprises, international listed companies, banks, PE funds and other financial investors.

Alan Free, senior vice president at Argo Consulting

Alan has worked in the consulting industry for over 20 years and currently leads the Chemicals industry practice. He is a high-level leader who has helped clients accelerate growth through transformational initiatives combining industry best practices and consulting expertise. It is his deep experience in business transformation, post-merger integration, and operations improvement that drives results.

Shay S. Kuperman, partner, energy transactions & projects at Vinson & Elkins

As a member of the firm's Energy Transactions and Projects group, Shay has extensive experience with many types of transactions, including project development, mergers and acquisitions, strategic joint ventures, and investments. He has been involved with transactions in many countries throughout the Americas, Asia, and West Africa.

Alan Free: The global environment makes it pretty clear this is not a short-term condition. The Saudi moves are worth watching closely, while the U.S. production has capability for reflating unconventional capacity like a coiled spring if oil prices somehow rise.

Paul Exley: USD50 oil is regarded as the new normal and no one expects a return to pre-crash price levels anytime soon. As mentioned in 1 above, oil and gas companies are coming to terms with this and making structural changes to their businesses to reflect this new paradigm.

Janet Duff: We've all heard lower for longer. Lying behind this compact phrase are several projections including production in the US from sources such as shale and fracking, increased international production as the bonds of OPEC loosen, and the potential return to global markets of production from Iran. All are factors which many expect to keep prices low for some time yet.

A few have speculated that, with underlying global demand for oil continuing to grow, as E&P investment declines causing projects to be cancelled, there will be a supply and demand re-balancing. Read this in tandem with rating agencies' reports, such as Moody's, that the downward pressure on costs is beginning to show results such that most integrated oil and gas companies' upstream production activity returned to positive earnings during 2016.

Michael Burns: The structural changes in supply, and potentially demand, likely mean that there is a long term impact for the sector, however, cut backs in development expenditure will likely come to have an impact and so there is a belief in the market that prices will recover to some degree in the medium term.

Oil & Gas Technology: Is the low oil price creating significant opportunities for cash-rich companies?

Michael Burns: Yes, but the issue is that there are not many cash rich oil and gas companies around now. What it is creating an opportunity for is funds that have raised investments specifically to invest in the oil and gas market, both private equity buyout funds and infrastructure funds.

Alan Free: Many companies are hunting for opportunities to pick up inorganic growth, but that can also cause a seller's market, and cash-rich players hope to avoid overpaying for new growth assets. Even the PE players are scouring the field looking for deals, but rigorous due diligence is mandatory.

Paul Exley: Yes. The low oil price is creating significant opportunities for cash rich companies. Traditional sources of finance are less readily available which is putting pressure on companies to find alternative sources or sell assets to raise capital. The quality of assets for sale has improved as sellers start to accept that selling marginal non-core assets doesn't go far enough, with some sellers packaging less attractive assets along with better quality assets to attract buyers.

Shay Kuperman: Yes. We are seeing companies with strong balance sheets and the ability to raise additional equity acquire acreage in areas that it considers core where they are able to remain profitable in this low-price environment. Some companies have been able to do an excellent job acquiring premier acreage during the downturn, such as in the SCOOP and STACK formations.

Oil & Gas Technology: Has this heralded a growth in mergers and acquisitions?

Michael Burns: To some degree. Shell/BG is an example of a deal that was at least accelerated by the reduction in oil prices. We are starting to see more deal activity, though a lot of it is driven by either companies that are restructuring or utilities that are seeking to exit the oil and gas sector.

Paul Exley: M&A activity is picking up as the gap in price expectations between buyers and sellers narrows and financing dries up. Deal terms are also evolving to facilitate transactions with contingent pricing, joint ventures and new capital structures becoming increasingly common. 2017 is expected to see a significant uptick in M&A activity. Big deals like the recently announced GE and Baker Hughes merger can help to unlock the pipeline.

Janet Duff: Rebalancing of portfolios leads to acquisitions and disposals, even in difficult times, so the market is rarely static, but buyer hesitancy (principally due to uncertainty around the long-term direction of the market) means that hopes of significant growth in M&A activity may be premature.

Oil & Gas Technology: Is this driven by pressure from banks and stakeholders, or are there other drivers?

Janet Duff: Oil and gas companies of different tiers have different approaches to finance, but whether they rely principally on equity finance, reserves-based lending or other structures (e.g. NOK bonds), all are under pressure to drive down costs, and rationalise their asset portfolios where possible.

Alan Free: When you see multiple announcements telling the same story of revenue miss but earning beat, that condition is typically unsustainable long-term. Stakeholders know this, and the pressure is very high.

Michael Burns: Yes. It is being driven by financing pressures, such as to improve cover ratios in debt financings, and by a need to maintain dividends, but, in addition, it is frankly just required business activity to keep operating following such a shock as the decline in prices that has been seen.

Oil & Gas Technology: Is this activity just amongst the oil majors, or is there increased activity amongst smaller and mid-size service companies?

Janet Duff: Majors may have the luxury of being able to take a longer view, and can continue to support projects through their long lead time, driving down costs nonetheless, on the assumption that the oil price will recover eventually and when it does, the flagship projects will come into their own.

Many smaller and mid-size companies may lack the flexibility to pivot their asset portfolio, or ride out lean times. Moody's identified that in the US, the second most distressed industry sector in 2015 was oil and gas.

The oilfield services sector, particularly in the UK, sees opportunities for offshore capability to be re-purposed towards decommissioning operations. The UK North Sea, a leader in developing offshore E&P technologies in the last century, now can lead again in developing the expertise required for safely and competitively decommissioning offshore infrastructure. Port operators have signalled investment to allow for landing of large sections of installations and their break-up. Industry associations forecast innovative technologies which will improve cost-effectiveness of decommissioning work.

Shay Kuperman: Companies of all sizes are involved in seeking to strengthen their balance sheets. We are seeing various joint venture structures being contemplated to link oil and gas companies with capital providers that remain hungry to invest in the energy sector. Despite the energy price downturn, given the desire to seek investments with attractive rates of return, we continue to see private equity firms remain interested in investing in energy transactions.

Alan Free: While major IOCs have already attacked weak or marginal units, especially upstream, more work needs to be done, and 2017 plans are already set. The service companies have seen slight improvement and again hunting for niche acquisitions, while harvesting pennies from previous deals over the past 5 years, so expect activity to pick up moderately.

Paul Exley: The activity is affecting all parts of the hydrocarbon supply chain from state owned enterprises and oil majors to the smallest service companies, as well as attracting new market entrants.

Oil & Gas Technology: Is this driven simply by synergies that reduce headcount and costs?

Paul Exley: Cost reduction is an important driver but having a strategic rationale is key. As mentioned above oil and gas companies are focusing on where they can add most value and looking to adjust their asset portfolios accordingly.

Michael Burns: In some cases, yes. Shell/BG is an example where synergies can be achieved. Other deals have different drivers, such as buying production to improve cover ratios.

Janet Duff: In many cases, M&A activity is driven by rationalisation, and focus towards the specific locations and types of project a company wants to be invested in. It's worth noting that nothing is simple about a headcount reduction. These decisions are never taken lightly. And in a complex industry reliant on detailed technical knowledge, skills and expertise, a company making staff redundant is losing know-how and hampering its own ability to recover quickly if/when the oil price picks up.

Oil & Gas Technology: How will this all reduce supply chain costs and deliver a more sustainable sector?

Michael Burns: I still think there is a way to go on this. I saw some statistics that suggested that the cuts had been deep, but there could be more to come. The service companies are not out of the woods yet!

Paul Exley: The focus on cost reduction should produce a leaner, more efficient industry better able to cope with the "lower for longer" landscape. Although there is some concern that some cuts will cause long term damage as well as sowing the seeds for the next price spike.

Alan Free: For the past year, while companies take air out of the balloon by getting lean operationally, they are also reducing excess inventory, and improving planning and scheduling functions to streamline the supply chain end-to-end. For other industries, these disciplines have been stable stakes, oil and gas players are catching

YOU ARE HERE

YOUR WELDER IS DOWN HERE

LN-25X

Flextec® 350X

Now the Two of You Can Talk.

More Control. Fewer Cables.

CrossLinc Technology™, now inside the New Flextec® 350X welders and LN-25X feeder.

On larger job sites, welding power sources are often hundreds of feet away from the work at hand, and there's no reliable way to control voltage at the feeder — until now. **CrossLinc Technology** sends voltage information across a standard weld cable without the use of an additional control cable, improving safety, productivity and weld quality.

Learn more at www.lincolnelectric.com/crosslinc

AR16-36 ©Lincoln Global, Inc. All Rights Reserved.

up fast by adapting new skills and behaviors in supply chain and operations. Watch for this to become the new normal.

Oil & Gas Technology: Is there a lack of capital in the industry at present, and if so, is this likely to change?

Archie Fallon: Yes, there is a wait and see approach among most commercial lenders and many private equity sponsors except for resource and infrastructure development in the most prolific basins. In those basins, there is still a significant inflow of private capital to back management teams acquiring acreage in the "core of the core" and developing infrastructure. Additionally, large independents are reallocating capex budgets to focus on these basins, and we see this reallocation continuing until there is a significant increase in the oil price deck.

Shay Kuperman: Traditional bank RBL lending is more difficult to obtain. However, private equity and alternative capital providers remain interested in energy investments. In addition, we have many examples of companies raising additional capital through public equity raises recently.

Alan Free: Capital access has not changed dramatically, but the criteria are changing. While not as volatile as the environment 18 months ago, hurdle rates and growth assumptions are shifting, and payback horizon is lengthening.

Paul Exley: There is a lack of capital in the industry with equity markets largely shut and bank lending becoming increasingly difficult to obtain, with asset-based lending and reserve based lending significantly curtailed. Private equity and other alternative capital providers can help to plug this gap.

Oil & Gas Technology: Are we seeing new investors enter this sector? If so, from where?

Archie Fallon: We are seeing a new wave of interest from Japanese, Korean and Chinese multinationals and national oil companies in upstream resources and infrastructure in the major shale plays, but competition is a challenge for them given longer approval processes relative to the speed of independents and private equity. They are largely seeking to export capital to obtain higher rates of return than what are available in their own domestic markets.

Alan Free: Private equity seems to have begun a new wave of bargain shopping in the sector earlier this year, and a few new funds were structured with focus here. Some of these plays are bottom-feeders, others have a value model looking for innovation in technology and services. Investors are also watching changes in capital structure in the sector, the shifts by operating companies and MLPs in midstream pipelines and NGL processing.

Janet Duff: There is some indication in the UK (following the lead of the US) that private equity is investing more in oil and gas opportunities. However, the long-lead times and the long tail of upstream decommissioning liabilities often does not sit well with the structures and life-cycle which private equity investors prefer; oil and gas infrastructure assets therefore tend to be more attractive opportunities for private equity investors.

Oil & Gas Technology: How are businesses going about remaining competitive in an age of lower demand and lower margins?

Alan Free: Beyond critical focus in operational savings, they have been stressed trying to sustain production and minimize outages, because any lost production today has a magnified negative effect. This classic balance between reducing cost and maximizing throughout is nothing new, but the stakes have never been higher at getting this right.

Archie Fallon: Many oilfield service companies are operating at almost no or negative margins to try to retain market share. In the upstream sector, the same businesses that were once rewarded by the capital markets for basin specific development at a high oil price deck have seen the strategy back-fire if their chosen basin has marginally economic production under a lower price deck. These companies are forced to de-lever if possible or undertake a restructuring in bankruptcy.

Paul Exley: Cost reduction and focused investment on where companies can add most value are key. There is also an increased emphasis on collaboration and efficiency. Technological improvements also have an important role to play and this is moving higher up the agenda as companies look to gain a competitive advantage.

Oil & Gas Technology: How can owners recover the value that has dropped from their business?

Archie Fallon: Owners deploy different strategies for recovering lost value based upon their market position and cost of capital. They can sell assets outside of their core holdings and use proceeds to de-lever their business, sometimes at the insistence of lenders. If they have capacity under lender arrangements, they can hedge commodity price risk to insulate themselves from further value erosion.

Oil & Gas Technology: What are the challenges that companies face in the short and mid-term?

Archie Fallon: In the short term, there are several factors that suggest continued crude oil global supply overhand, including the inability of OPEC to agree upon production quotas or reductions and the high inventory of drilled but uncompleted wells in the US. In the mid-term, manufacturing economics in BRIC countries are anticipated to grow and require more oil consumption, which could have positive effects on pricing. From a US regulatory point of view, over the mid-term, oil and gas production and processing activities could face increasing scrutiny based upon new gas emissions standards under a new administration.

Paul Exley: In the short term the challenge remains to cut costs and preserve cash without unduly damaging future growth prospects. In the medium term the main challenge is to develop a focused, profitable business model which distinguishes companies from their peers and enables them to obtain working capital and growth capital on attractive terms. ■