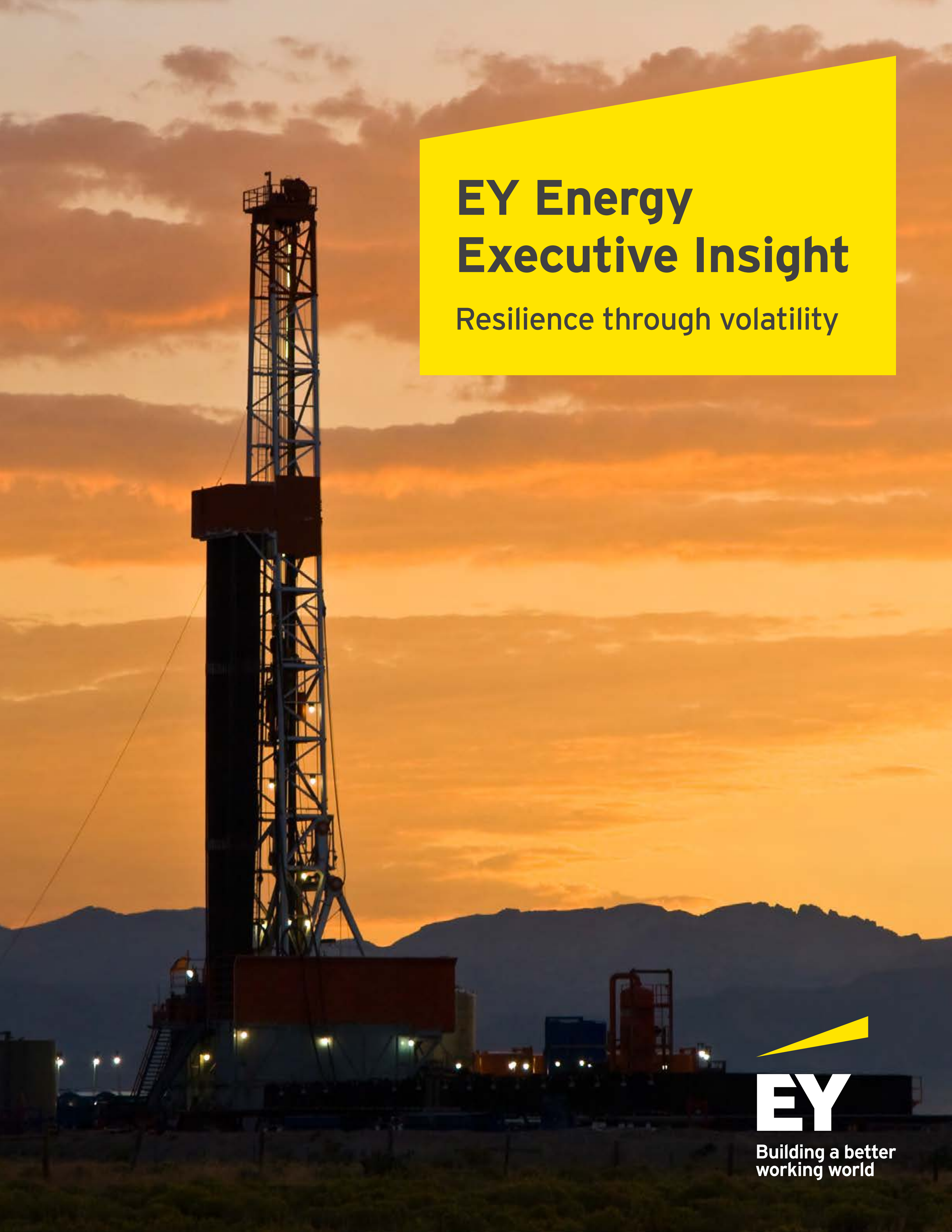

EY Energy Executive Insight

Resilience through volatility

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Building a better working world

EY Energy Executive Insight:

Energy companies responded to the 2014 collapse of crude prices by pulling all the traditional levers that enable them to reduce costs and adjust to market conditions. But what if this era of low prices — the result of energy abundance here in North America and around the globe — isn't just a temporary condition, but a fundamental change? How can smart companies move from tactical adjustments to long-term strategies that enable them to prosper? EY recently hosted its annual Energy Executive Insight Session to discuss the issue.

Background

Recent history suggests we have transitioned to a world of energy abundance — where global supplies will continue to grow over time and worldwide demand flattens. North American shale production is as strong as ever, Mexico and Canada continue to offer promising opportunities, and new discoveries around the globe, aided by technology, continue to come online. At the same time, new efficiencies and sluggish economic growth combine to dampen energy usage in both developed and developing countries.

US companies responded to the rapid decline of crude prices by paring costs, reducing staff, improving balance sheets and generally following the playbook that has served the industry well in previous low-price markets. But increasingly, industry experts are coming to the realization that US$100-a-barrel oil is not coming back any time soon, and tactical changes may not be enough to sustain many companies during an extended period of low prices. New strategies are needed to help companies compete effectively in a new era.

To provide real-world guidance into current conditions and how leading energy companies are managing, EY invited oil and gas professionals to a half-day seminar on 10 September 2015, titled "Resilience Through Volatility," in Houston. More than 250 attendees heard from a distinguished lineup of industry panelists along with professionals from EY. This report provides a brief overview of the discussion.

Resilience through volatility

Discussion highlights

"We've moved from scarcity to abundance — from concerns over peak oil to concerns over peak demand. This is not a temporary downturn that will be solved easily."

Experts believe there might be a price bounce here and there, but the market won't experience a sustained period above US$50 a barrel for the foreseeable future.

The idea that this downturn would be short-lived was based on three widely held — but incorrect — assumptions:

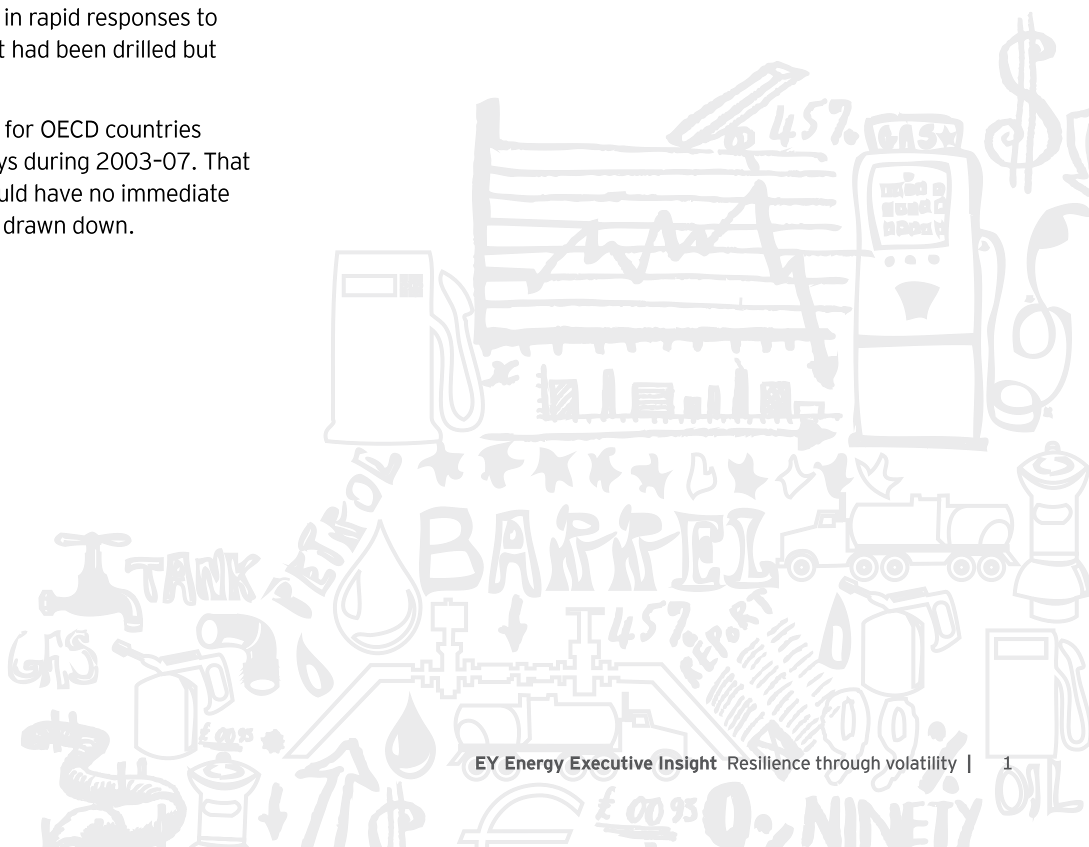
1. US production will fall off sharply as oil drops below US$75 a barrel. Shale production has actually increased somewhat, and overall domestic supply has remained flat despite lower prices.
2. Lower crude prices will increase demand. While demand has picked up slightly in some markets, it is still running short of incremental supply.
3. Prices will rebound as the market adjusts. Short-term recovery is continually hampered by growing inventories, storage gluts and new production from US shale in rapid responses to price increases, primarily from wells that had been drilled but not completed.

Today, the average inventory forward cover for OECD countries is 40 days and climbing, compared to 37 days during 2003–07. That means even substantial production cuts would have no immediate impact on pricing until this inventory glut is drawn down.

"No one in OPEC is happy with US$50 a barrel oil, and it can't continue indefinitely. But the question is whether or not the organization has the will to force cuts in production."

Currently, global production is about 1.5 million barrels a day over demand. At those rates, it is estimated that OPEC would need to cut production by 3.5 million to 4.5 million barrels a day to have a significant impact on the market, and it would take three months of that lower production for current inventories to be sold off enough to push prices higher.

The issue is that "sharing the pain" by having multiple members make cuts in production is a difficult proposition, as the levels of financial vulnerability vary widely across the organization. Given the current economic and political situations in many OPEC countries, coordinated action between multiple members is not likely in the short term.



"The price drop isn't the only issue facing energy companies. Investor concerns about the industry's ability to deliver competitive returns have been growing for some time."

As energy projects have grown in size and scale, the escalation in execution costs has made many investors wary of the industry's ability to deliver promised returns. That fear has only grown stronger as prices have fallen, making many planned projects even less economic.

The era of abundance is shifting perceptions of value creation away from reserve acquisition toward efficient project execution, free cash flow and discipline in capital spending. "Value over volumes" is not just a catchy phrase; it's the way many institutional investors will evaluate energy companies going forward.

The focus on cash flow has many companies adopting a range of new strategies: delaying or deferring new projects, dedicating specific management teams to tackle project execution challenges, standardizing project design elements to reduce costs, gaining relief from local content obligations, and optimizing costs through supply chain management and service sector contract renegotiations.

In addition to reducing capital spending, companies are rethinking their project pipelines and re-prioritizing their plans to increase their focus on opportunities with the greatest potential. This has a definite impact on joint ventures; companies that are the non-operating partner can get burned by delayed projects.

"Independent E&P companies are facing unique challenges that will require many of them to adapt ... or else."

Independents focused heavily on exploration thrived over the past decade. Many found niche resource opportunities and moved quickly to take advantage, often by de-risking properties and flipping them. Today, these firms find themselves under intense financial pressure. Many are cutting back on exploration — some companies cut their exploration budgets by 80% to 90% percent — and are striving for more of a "portfolio manager" approach, with a focus on the most economic development projects.

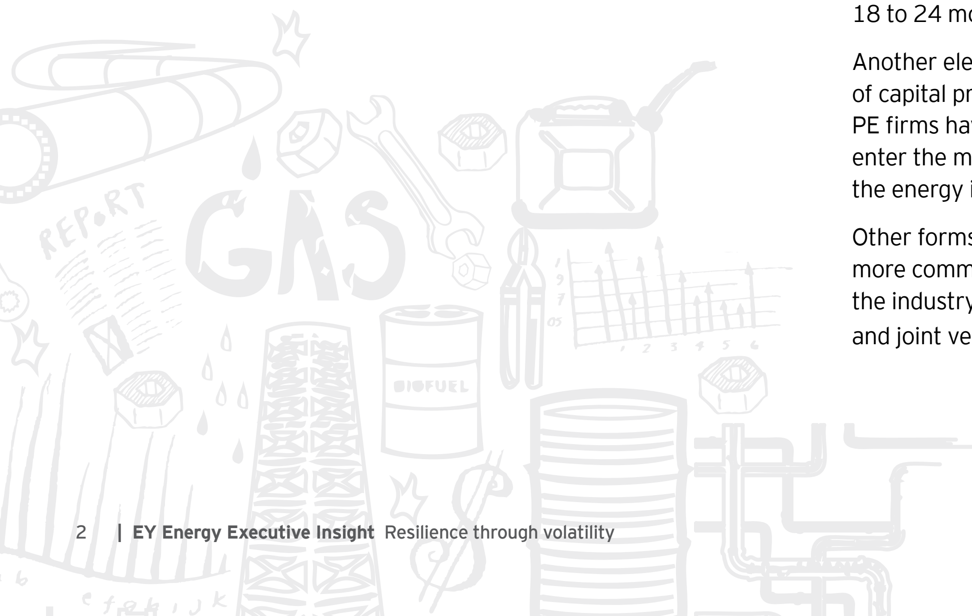
Though the skill set needed in exploration is very different from project execution, the larger independents will likely be able to make this transition successfully, evolving their strategies over time. But smaller international independents, some highly leveraged, must move more quickly to learn to develop projects rather than just explore.

"We have yet to see some of the major changes that the drop in oil prices will eventually bring. This is just the beginning."

The panel of experts predicted the wave of M&A activity was just beginning, with several of the strongest companies standing pat and waiting for even better opportunities. At the same time, there are a number of companies in need of cash and looking to sell assets quickly to avoid serious trouble, and well-financed companies will likely make some bold deals in the months ahead. All agreed that it is likely we will see independents feature prominently in merger and acquisition activity over the next 18 to 24 months, both as buyers and sellers.

Another element likely to affect the industry is the vast amount of capital private equity has amassed for investment in energy. PE firms have an estimated US$60 billion in capital ready to enter the market, and many of those firms are newcomers to the energy industry.

Other forms of nontraditional financing will likely become more common in the months ahead. The panel also predicted the industry will see an increase in stock-for-stock deals and joint ventures.



"Some good news for the industry: Congress is moving toward lifting the ban on crude oil exports, which would give domestic producers new opportunities and help strengthen the US economy."

The ban on crude oil exports, enacted in the midst of the OPEC oil embargo of the 1970s, is outdated in this era of energy abundance. There are signs that both the House of Representatives and the Senate are ready to pass legislation lifting the ban; the House Energy and Commerce Committee approved a bill in early September that would end the ban and sent it on for a full vote expected later in the year.

Some benefits of crude exports are obvious, such as more domestic drilling, better employment opportunities for workers and improved local economies. Others are more strategic in nature — oil exports can help strengthen the US geopolitically by offering a new supply option to countries that rely heavily on imports.

Congress' work toward lifting the ban is just one element of a broader legislative effort aimed at changing US policy in an era of abundance. The Energy and Commerce Committee in the House, for example, is developing a plan that would support "all of the above" energy development and encompass a broad range of issues, from streamlined regulations to climate change.

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