EUROPEAN OIL AND GAS MARKET UPDATE

April 2015

ALVAREZ & MARSAL

OIL PRICE

February and March have been extremely volatile months for oil price. During February there was a 30% surge in price and as predicted in our last market evaluation, the recovery appears to have been founded on sentiment rather than fundamentals. This is reflected in the subsequent 16% fall in price that occurred mid-March. Recent Saudi military action in Yemen has caused price to briefly trend back up. Fundamentals continue to weigh upon price: US oil production is still rising and rather than going into enhanced demand, it has contributed to what are now record US oil stocks. The market continues to try and find direction.

For near-term outlook, choose your letter! Many industry participants have predicted a rapid V or more gradual U-shape return to $70/bbl+ oil price, with an expectation that rig count cuts will finally eat into US production in the second half of 2015. In contrast, led by the likes of BP and the IEA, others are warning of an L-shape future where prices remain as they are ($50-60/bbl) for the next few years. Commentators such as former ENI executive Leonardo Maugeri, point to shale oil as having changed the fundamentals. He claims that any oil price recovery would mean that "most shale formations will be aggressively exploited" causing any material oil price rise to be quickly moderated.

Furthermore, Norbert Ruecker, head of commodity research at Julius Baer believes that rapid technology and productivity gains will mean materially lower marginal costs, causing further deflationary pressures to oil price.

A&M VIEW

L-shaped recovery may be the base case

Ultimately, in the absence of a belief in OPEC's control of supply, US shale based production becomes a key determinant of market balance and price. Whilst offshore wells such as those in the North Sea, can cost tens of millions to drill and many years to reach production, US shale oil wells may cost several million dollars and need only months to go into production. Shale players have made remarkable progress in moving down the production cost curve using technology and learning. We believe that the industry is unlikely to see the rapid V-shaped price recovery experienced after the 2008 plunge. Since then, the large scale exploitation of shale formations has fundamentally re-defined supply capability. Alternatively, the next 3 - 5 years may be characterised by an L-shaped price trajectory, as seen in the 1990's. During this period, record production from Alaska, Russia and Saudi Arabia kept oil price in check.

The European industry must prepare for the real risk of sustained low oil prices. Standardisation of equipment, greater industry collaboration and avoidance of 'gold-plating' are all trends we refer to in this paper.

Being pro-active in reducing cost and strengthening the balance sheet will inevitably pay dividends in a downside oil price scenario, as well as the more benign possibility of oil prices remaining at current levels for another 12 - 36 months.

Impact of Price Hedges

Hedging is proving to be a near-term saviour, as well as cautionary signal for independent oil companies. The impact of hedges may currently be masking the degree of stress in the industry. As the UAE Energy Minister Suhail Bin Mohammed al-Mazroui points out "There are companies which are hedged until the beginning of the year or until the end of the year, so we need to wait at least until the first quarter to see what is going to happen". A selection of London listed oil E&P players demonstrates that hedges are typically in place for at least 50% of 2015 production and that many executed these positions before the recent crash in oil price (figures below taken from 2014 Company Annual results) :

- Tullow Oil has 60% of 2015 sales hedged at $86/bbl
- Premier Oil has 50% of 2015 at $98/bbl
- Ithaca Energy has 50% of 2015 at $102/bbl

Accordingly, rather than feeling the impact of c$55/bbl oil, many are actually effectively experiencing $70/bbl+ oil price. This situation will change as these hedges are replaced throughout 2015, with greatest impact coming into effect in the second half of the year.

A&M VIEW

Futures prices a key reference point

E&P company analysis should consider two points:

1. The possibility of a return to $70-100/bbl should not be the justification for current cost levels. Stakeholders should use futures markets as their only certainty and ensure that industry players are taking material steps to adjust to a potential benign scenario of a 12-24 month period at around today's prices, as well as test at a downside scenario of $30-50/bbl.
2. For most independents, hedging should be a systematic exercise and not discretionary. A lower price environment (compared to 2014) and potentially misguided belief in a near-term return to high prices could encourage producers to reduce hedged volumes. This would by definition be a speculative activity.

The benefit of hedges suggests that we have only seen the start of distress in the industry. Though many have hedged at $80/bbl+ levels in 2014, hedging today would entail a 25% reduction in income for the same hedged volume.

March Budget Tax Concessions

The Chancellor George Osborne announced a package of tax concessions for the North Sea. Measures included:

- Petroleum Revenue Tax levied on older (pre-1993) fields cut from 50% to 35%
- Reduction in Supplementary Charge from 30% to 20%
- Introduction of a single, simplified Investment Allowance equivalent to 62.5% of field investment
- £20m to fund offshore seismic work

These tax changes reduce the marginal tax rate from 80% to 67.5% for older fields and 60% to 50% for newer fields.

Sir Ian Wood commented "...the Budget does provide the essential lifeline from Treasury to enable industry to start rebuilding confidence and investment in the UKCS."

In contrast, Jon Fitzpatrick, Macquarie Capital's head of oil & gas said "In reality, these concessions will likely only benefit the handful of tax-paying North Sea producers and will not address the much larger, structural issues facing the North Sea oil and gas industry."

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A&M VIEW

Tax impact limited – self-help is key

It is estimated that up to a third of North Sea operators are loss making on a cash basis - therefore not paying tax. Fiscal measures, even if they cost the Government £1.3bn in lost tax revenues over five years, are unlikely to be sufficient in stabilising the situation.

The industry cannot therefore rely on the Government to sustain its future. We believe that it is incumbent upon North Sea operators to find material self-help measures to reduce operating costs. Potential themes could include:

- Applying shale oil learning to offshore production
- Greater collaboration between operators at the operational level and with equipment providers
- More open access to oil and gas pipeline infrastructure

The recent establishment of the UK O&G Industry Regulator, under the leadership of Andy Samuel, may provide the coherent voice needed to drive change in the industry.

Industry Collaboration

Two interesting trends have emerged in subsea services:

- FMC Technologies mid 2014 announcement of a joint-industry programme with Anadarko, BP, ConocoPhillips, and Shell focusing on HP/HT wells. The objective of the initiative is to seek new innovation and standardisation of subsea equipment.
- Several alliances between subsea equipment and service providers, including Cameron and Schlumberger (2012), Aker Solutions and Baker Hughes (2014) and FMC Technologies and Technip (2015).

A&M VIEW

Potential for private equity to create change

Alliances are an ideal means of breaking down interfaces, enhancing innovation capabilities and sharing risks. Standardisation, facilitated by joint operator initiatives, is also a key means of driving down cost.

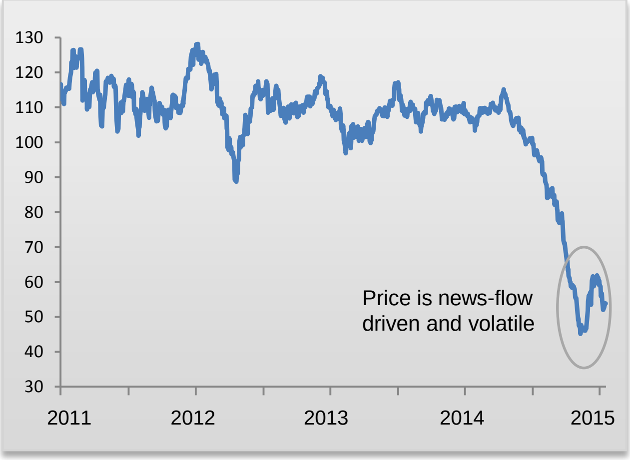
To date joint-ventures and other forms of alliances have been the major route used to provide coordination. There is the potential for private equity to serve the same role as the industry ventures in providing e growth capital to enable consolidation between oil field service players.

In the current oil and gas environment, many companies need the support of experienced professionals who can work alongside management to deliver solutions to complex problems.

Founded in 1983, Alvarez & Marsal is known for its distinctive restructuring heritage, hands-on approach and relentless focus on execution and results. A&M works with clients across the energy investment life-cycle in the following ways:

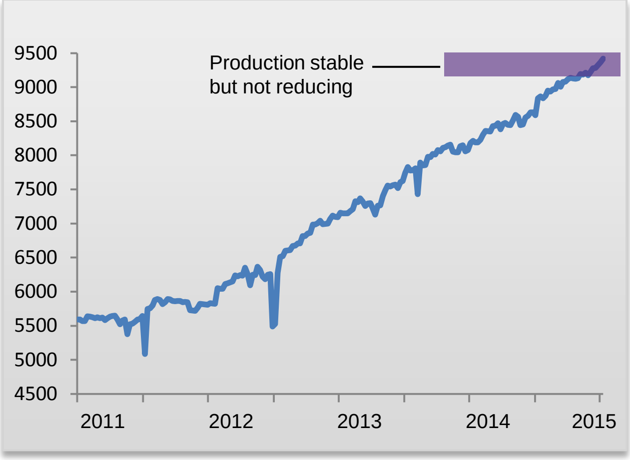
- Assisting companies pursue acquisitions, mergers or divestitures with financial and operational due diligence, valuation, tax structuring and acquisition/carve-out integration planning and execution.
- Working with management to optimise cost and CapEx, analyse asset performance and portfolio prioritisation, identify divestiture opportunities, and improve the company’s planning and financial control processes and systems.
- Support management, legal and financial advisors of distressed companies to stabilise operations and cash flow, thereby extending their “liquidity runway”.
- Providing interim management positions as appropriate.

Brent Front Month Oil Price ($ / bbl)



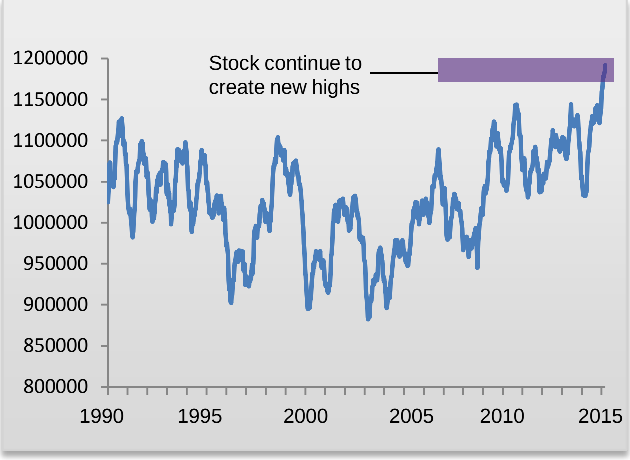
Source: EIA

U.S. Crude Oil Production (kbbl / month)



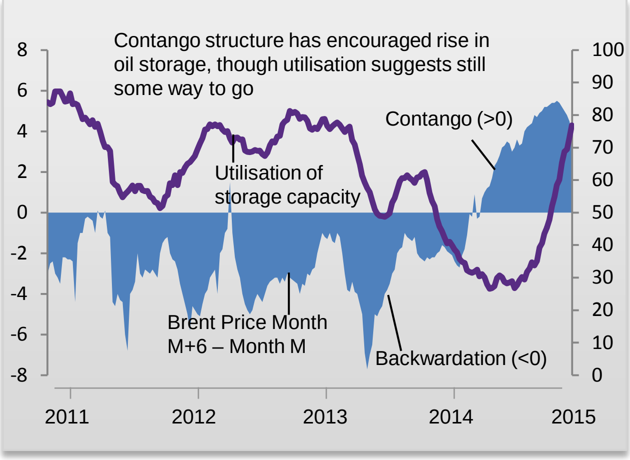
Source: EIA

US Crude Oil Stocks (Exc SPR) (kbbl)



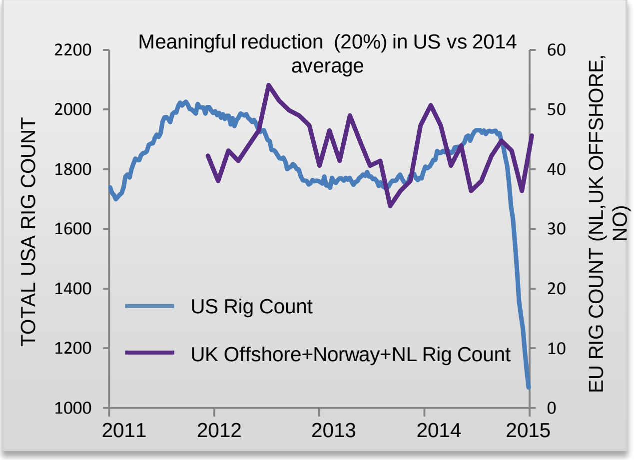
Source: EIA

Brent Month M+6 – M ($ / bbl) (LHS) and Cushing* Utilisation (%) (RHS)



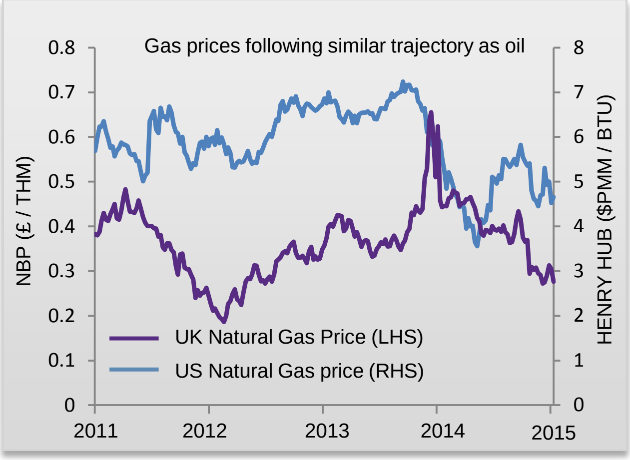
Source: Bloomberg, EIA

Rig Count



Source: Baker Hughes

Gas Price



Source: CapitalIQ. EIA

* Cushing OK is a key independent crude oil storage location. Current capacity around 71 mmbbls

CONTACT US

To discuss how A&M might provide assistance with Transaction Services, Operational Performance Improvement, Restructuring or Interim Management please contact any of the following:

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