EUROPEAN OIL AND GAS MARKET UPDATE

September 2015

OIL PRICE

Commentators are being forced to reach for their thesaurus as they run out of adjectives they could use to describe the oil price journey over the last month. First, oil price fell by 25% from the beginning of July until the 25th of August, surpassing the low achieved in January 2015, along with Brent achieving a 6 year low of $43.4/bbl. The rout appears to have been propagated by demand doubts relating to Chinese growth and the risk of a Chinese led recession. With supply signals continuing to be negative (excess supply, high stocks, limited change in U.S. production), oil market sentiment became somewhat panicked as the Central Government was forced to intervene in order to support slumping Chinese shares. By late August, it appeared that little could arrest the ongoing decline of oil price.

Just as hope seemed lost, the market regained a considerable 21% over a day period. A timely combination of Central Government intervention in the Chinese stock market, unexpectedly optimistic U.S. economic growth, slight reduction in U.S. commercial oil stocks and a shutdown of 180 kbbl/day Nigerian production appeared to be sufficient to jolt the oil market again, but this time to raise price.

So was the prior price drop an aberration, with normality now resumed? Few commentators expressed such confidence. As reported in the Wall Street Journal, Anuraag Shah, portfolio manager of Tusker Capital commented that the price increase *".... is nothing more than short-covering"*. Thin trading volumes (less than 30% of recent averages) were seen to be a factor in amplifying the upward move.

A&M VIEW

“Hope rather than fundamentals”

Once again, the oil market has demonstrated a tendency to reflect hope rather than fundamentals.

A sustained recovery in price would appear to be contingent upon major cuts on the supply side. OPEC provided some hope in its most recent bulletin, stating that *"... it stands ready to talk to all other producers. But this has to be on a level playing field."* This was reflected in discussions being reported between Russian President Vladimir Putin and his Venezuelan counterpart Nicolas Maduro. However A&M would caution placing too much significance upon OPEC's signal. Significant pressure to address budget deficits that have been ravaged by low oil price means that few OPEC members or other major producers such as Russia can afford further cuts and would appear to be looking to others to strengthen the market.

Meanwhile, Oil & Gas UK in their most recent Economic Report, have referred to the perilous state of the North Sea industry *“…when the total revenues from the UKCS as a whole are compared against the combined expenditure on investment, exploration, operations and decommissioning, the basin is seen to be cash-flow negative, on a post-tax basis.”* They go on to warn that in 2014, at a $50/bbl oil price, almost 20% of oil production was cash flow negative.

A worrying signal is that the CBOE crude oil volatility index (OVX) has continued an upward trend, last seen just before the 2014-15 crash in price. With falling markets typically considered more risky, such a rise in implied volatility is often indicative of an impending price deterioration, as investors rush to buy options protection.

With continued poor fundamental signals and worrying financial market effects, we continue to caution market participants and encourage that they position themselves to better cope with a scenario of sustained lower oil prices.

Shell – Arctic Drilling

After $6.6 bn spend to date and 7 years since purchasing the acreage, Shell has finally received the Obama Administration's consent to drill in the Arctic's Chukchi Sea. The journey to this point has been extremely arduous for Shell, having had their progress previously halted by the Macondo disaster in 2010, the Kulluk drilling rig running aground in 2012 costing $200m, as well as the typical trials of the short seasonal drilling window and the obvious logistical challenges.

In addition to this, Arctic drilling has drawn vocal protests. Taking to Twitter, Hilary Clinton commented *"The Arctic is a unique treasure. Given what we know, it's not worth the risk of drilling."* Greenpeace has organised numerous protests; including Charlotte Church singing outside Shell's HQ!

In conjunction with the environmental concerns, many have questioned the economics of Shell's decision. Charlie Kronick from Greenpeace commented earlier this year *"Despite announcing cuts, Shell hasn't taken the opportunity to cut its most high-cost, high-risk project."*

A&M VIEW

"Taking the long-view"

Shell's strategy does appear contrarian – spending c. $1 billion p.a. on a drilling programme that has so far yielded no oil and in which any development would be 10-15 years away. Shell is also cutting $15 billion of future capex out to 2017. So why continue with the Arctic bet?

Three key reasons can be identified:

- The drilling challenge is relatively benign in terms of water depth and well pressure
- Shell's strategic thinking is strongly influenced by their scenario planning analysis which has indicated that renewables will be insufficient for future demand – Arctic oil will be a vital part of the energy mix
- Arctic waters are said to hold 13% of the world's undiscovered oil. Shell is betting on having first mover advantage in a potentially enormous new province.

Shell is taking the long-view despite the net present value challenges.

Schlumberger Acquisition of Cameron

In a deal that, according to its CEO Paal Kibsgaard *"opens new and broader opportunities",* Schlumberger may have instigated the much anticipated wave of mergers with their $14.8 billion take-over of Cameron International. Industry watchers have agreed with Kibsgaard that the compelling logic for the deal is to create a *'one-stop shop'* from the combination of Schlumberger's reservoir and well technologies, with Cameron's surface, drilling and flow control technologies.

The two parties know each other well, due to having partnered in the Onesubea joint-venture since 2012. Schlumberger has a history of acquiring its partners, as demonstrated by its 2010 take-over of Smith International.

Though not on the scale of last year's $35 billion merger of Halliburton and Baker Hughes, Schlumberger have paid an eye-watering premium of 56% to the closing stock price of Cameron from the day before the deal announcement. Are Schlumberger calling the bottom of the market?

A&M VIEW

"Leveraging innovation is key"

When low cost service provision is essential to the industry, it's hard to argue with the logic of creating a 'one-stop shop' for oil field services; but how is value ultimately created? Schlumberger anticipate $600 million of synergy benefits in the first two years. It's doubtful much of this could come from organisation synergies, since there is limited over-lap in product focus. Instead investors need to believe for the next two years in the supply chains and manufacturing process synergies. Some confidence can be taken from the fact that Schlumberger returned around twice their original estimates for synergies from the Smith deal.

The real story here may be the indication that joint ventures are ultimately insufficient to compete in today's harsh environment. This deal may be the proof that the innovation required for low cost service provision can only truly be delivered by breaking down the organisational walls and creating a seamless entity. We watch Cameron peers - Aker and FMC Technologies – and their JV partners with interest.

Total Infrastructure Disposals

On the 27th of August Total announced their divestment of a number of North Sea infrastructure assets. The 220-mile Frigg U.K. pipeline and 67% of the 140-mile Sirge pipeline, as well as their 2,648 million cubic feet of gas per day associated St Fergus processing terminal. Supplying over 18% of the U.K.'s demand, the St Fergus terminal processes gas from over 20 North Sea fields.

The sale is for £585 million to North Sea Midstream Partners (NSMP), an affiliate of ArcLight Capital – owner of the Teesside Gas Processing plant (TGPP).

Despite this and other recent disposals, such as their 20% of the Laggan Tormore gas development, Total have insisted they will remain committed to the North Sea for many years to come.

A&M VIEW

"A natural step and good for the industry"

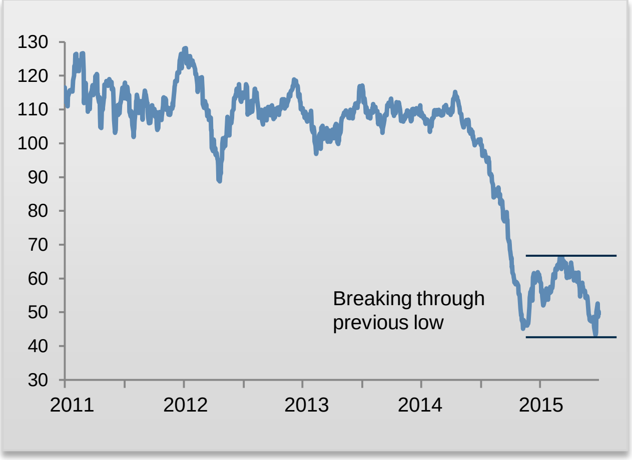
The deal may look like another alarming example of an oil major seeking to exit the North Sea. A&M's contrary view is that the deal is likely to be an example of what is required to prolong the life of the North Sea. With Frigg field decommissioned in 2004, the infrastructure has long been non-core for Total. For the industry, having the infrastructure in independent hands reduces the potential for conflicting producer strategies to inhibit development and cost improvement. NSMP have handed operational management to PX Group, a company experienced in efficient, late-life operation. PX Group has been the operator of the Arclight owned TGGP since 2002 - processing CATS and Breagh gas. Will other oil major infrastructure owners follow suit? We expect so.

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:

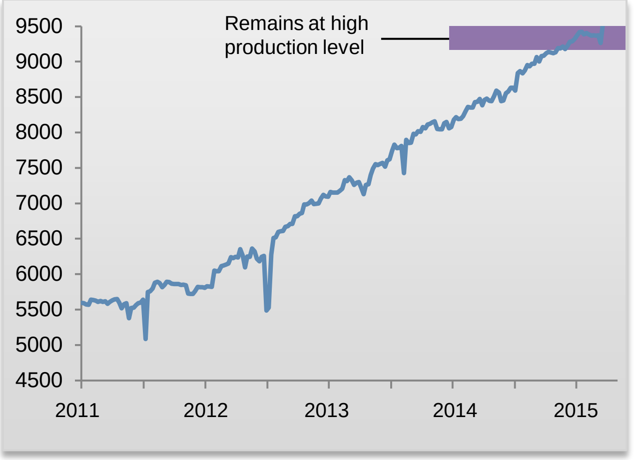
- Assisting companies pursue acquisitions, mergers or divestitures with financial and operational due diligence, valuation, tax structuring and acquisition/carve-out integration planning and execution.
- Working with management to optimise cost and capex, analyse asset performance and portfolio prioritisation, 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)



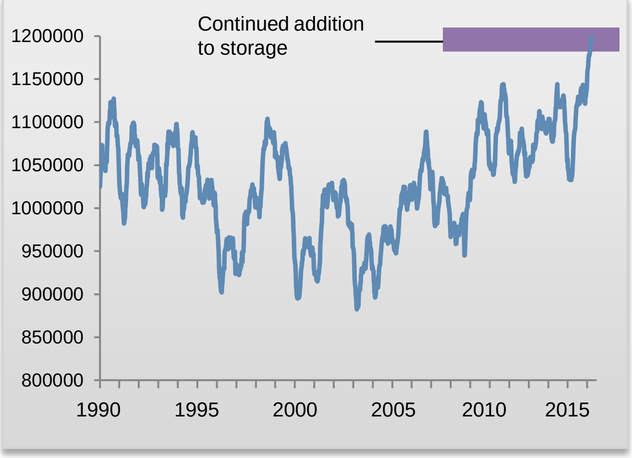
Source: EIA

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



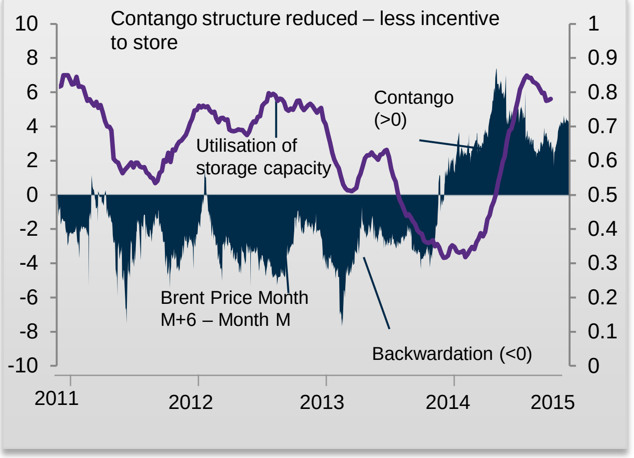
Source: EIA

U.S. Crude Oil Stocks (Exc SPR) (kbbl)



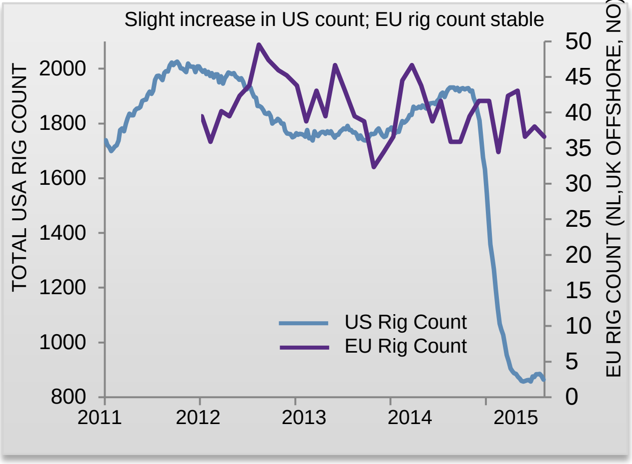
Source: EIA

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



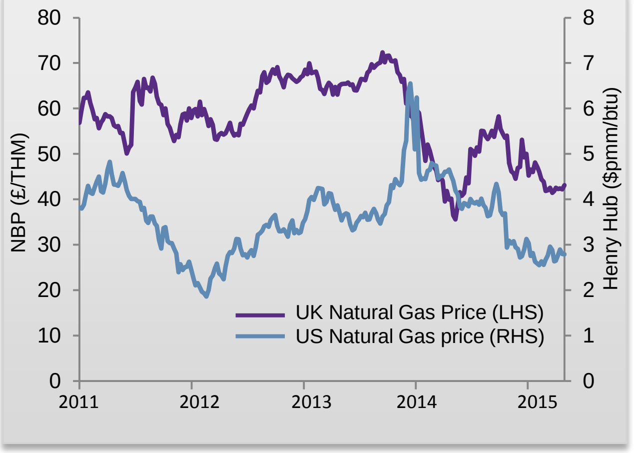
Source: Bloomberg, EIA

Rig Count



Source: Baker Hughes

UK Gas Price



Source: Quandi

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

CONTACT US

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