EUROPEAN OIL AND GAS MARKET UPDATE

April 2016

ALVAREZ & MARSAL

OIL PRICE

With improving fundamentals and the market pricing positively in anticipation of the 17 April Doha meeting of OPEC and Russia, Brent edged above $44/bbl in early April, levels not seen since November 2015.

Fundamental factors support price, with Baker Hughes reporting the U.S. rig count at the lowest levels for 10 years: 354 (47 percent versus April 2015). U.S. output is now below 9 mmbpd versus 9.7 mmbpd in April 2015. U.S. crude inventories fell in early April.

Another signal of market strength is the reduced Contango price structure. WTI in mid-April trading for prompt delivery at a $1.70/bbl discount versus price for October delivery; the lowest level of Contango since August 2014. Caution should be applied in viewing the reduction as a sustainable feature, some of this strength may be attributed to planned field outages and strike action in Kuwait.

Those looking for higher prices had hoped for a positive outcome from the Doha meeting. However, we were not alone in being more pessimistic; Goldman Sachs see a supply freeze as negative to price, claiming sustained lower prices (c. $35/bbl) were instead needed to re-balance the market.

Lack of agreement at the Doha meeting almost evaporated positive sentiment. Saudi Deputy Crown Prince Mohammad bin Salman, insisted that an output freeze would need participation from Iran. Iranian Oil Minister Bijan Namdar Zangeneh said that a freeze would be a "sanction on ourselves". At the time of writing, perhaps the only thing averting a sharp drop in oil price is a strike by Kuwaiti oil workers.

A&M VIEW

Three key factors to watch on the demand side

Whilst the supply side is claiming most of the headlines, it's also critical to have one eye on the demand outlook. We highlight three key considerations:

1. **Chinese demand:** GDP of 6.7 percent in mid-April is on the one side continuing the downward trend seen in 2015 and is now at the lowest quarterly level since the financial crisis; yet on the other side was within government targets of 6.5 – 7 percent. The question is whether levels are sustainable or require the government to continue a hazardous path of stimulus support.

2. **Refinery margins:** High refinery runs have provided integrated oil producers a degree of mitigation against upstream losses. However, early 2016 continued the trend of Q4 2015 with Scotia Howard Weil reporting NW Europe refining spreads below five year averages: Reduced margins demonstrate the fragility of global economies and over-supply of refining products. Rising crude and product stocks could be one worrying outcome going forward.

3. **U.S. interest rates:** A strong U.S dollar is a negative demand driver, as it increases the cost for non-U.S. denominated importing countries. April has seen a continued weakening of euro versus dollar. Recent signals are that the Fed is likely to take a more cautious approach to the pace of interest rate rise, due to the risk to outlook. Whilst this view maintains, oil demand and price is supported, but it is a factor to watch.

LOWER FOR LONGER

'Lower for longer' neatly encapsulates one of the key working assumptions on oil price that is currently driving strategic decisions across the world. Operators in all markets, and particularly those in relatively high production cost areas such as the U.K. Continental Shelf ("UKCS"), are recognising the need to react to new realities and reshape their business models accordingly. When you consider that at a price of $40/bbl approximately 35 percent of UKCS oilfields are cash negative, the need for change becomes ever starker.

Recent industry workshops with A&M have illustrated the size of the challenges being faced, but also the benefits that can be achieved when the correct plans are developed and actions driven. In one notable example, a major producer halved their average UKCS field breakeven oil price from $38/bbl to $19/bbl. Such transformational change, if managed correctly, has benefits beyond the obvious initial profit and cash implications. Strategic options, acquisitions and enhanced dividends are among the potential benefits, together with enhanced supplier terms, credit insurance availability and employee morale.

A&M VIEW

Need meets opportunity

With the exception of relative few existing producers with very low production costs, the need to respond actively to the likely 'lower for longer' scenario is a key (and for some a potentially existential) requirement for producers around the world. This need also brings real opportunity, in that many participants across the supply chain recognise the challenges posed by the current market and in many cases are willing to enter constructive discussions with a view to securing future business and cash-flow.

Such supply chain benefits are an important part of a transformation plan for all producers and service providers across the industry, given the challenges faced. In addition, operations and internal support services should be critically reviewed and rethought with an aim to remove excess complexity and costs, and increase relevant visibility, responsibility and accountability. These actions will bring real benefits, but what will make them sustainable is a required realignment of the culture within the business. This is often the hardest part and needs to be at the very heart of a successful transformation programme.

NORWEGIAN OIL SECTOR

The Norwegian economy is highly dependent on the oil and gas industry. Since late 2014, the Norwegian Krone has devalued 17 percent against the euro and 40 percent against the dollar.

The prodigious fall in oil price has taken its toll in the O&G industry, with bankruptcy cases filed in seismic and supply vessels companies. Companies have responded, as those in the U.K., with down-manning exercises to adjust cost and capacity. Financial restructuring has also been a key theme; in many cases banks and bond holders have accommodated extensions and covenant waivers.

International distressed funds and private equity firms are focusing on Norway as relative pricing and the underlying quality of companies looks attractive against a post-cycle scenario. Exploration in Norway is relatively attractive (e.g. vs North Sea) due to the tax deductibility of associated costs.

The climate between secured and unsecured lender groups will become tougher after the recent bankruptcy filing of Atlantic Offshore. The banks supported a new owner group with an asset buyout, and unsecured bondholders were left behind with 100 percent loss in the bankruptcy.

A&M VIEW

Need for Management team support

The OilCo's (with Statoil representing more than 50 percent of spending in NCS) are demanding significantly lower rates in long-term frame contract renewals, creating a need for more drastic operational and strategic restructuring through the entire value chain. Entirely new business models will be required to meet the overall cost reduction targets set by the OilCo's. Contract formats and client-supplier interfaces have to be optimised, technology simplified and standardised, and an in-depth review of documentation requirements must take place.

The need for radical cost reduction and improvement programmes creates a strong pressure on management. Corporate managements have experienced 10-15 years of upturn cycle with focus on growth, and many have never been exposed to the level of distress facing them.

Experienced stakeholder management in distressed situations is a scarce resource, and proactive actions are required. A&M is tuned to assist in this tough environment.

DOMINO EFFECT OF HUBS

Historical investment in the network of 'hubs and spokes' of pipelines and onshore processing have greatly lowered the cost to market for smaller North Sea Fields. As pipeline flows diminish in late economic life, there is a risk of the domino effect of other field closures, as those left shoulder the burden of transport and processing costs.

This risk is exemplified by two recent examples: Marathon have indicated their intention to close the Brae fields in the coming years. The Alpha, Echo and East Brae platforms form a hub for 13 other oil fields for onward transport. In addition, ConocoPhillips have indicated an intention to close the Lincolnshire Offshore Gathering System and Theddlethorpe gas terminal; a system linked to 10 other gas fields, representing 10 percent of U.K. gas.

A&M VIEW

Learn from the Chemical Industry

Closure of hubs represents a serious existential threat to North Sea production – particularly as such closures may cause earlier than otherwise intended field exit.

The oft-forgotten consequences of sharing infrastructure in late life, is a scenario that has also been faced by the Chemical Industry and lessons can be learned. In particular, there is a need for such assets to be in the hands of specialist infrastructure firms who can focus time and investment funds into optimising costs and making necessary investments. Chemical parks, with owners such as Sembcorp, Infracor, and Currenta have extended the life of threatened production hubs.

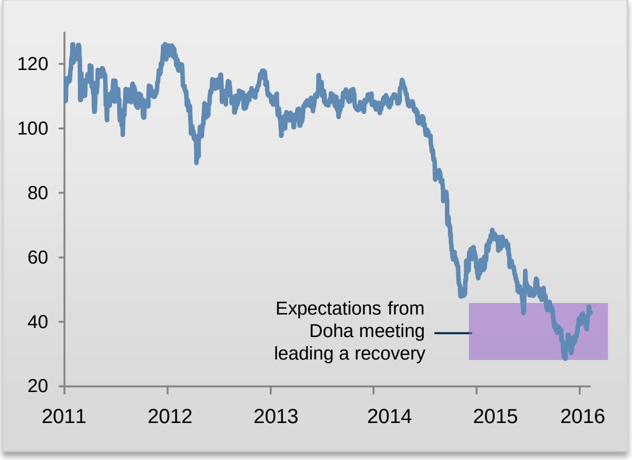
Government support and facilitation will be required and the domino risk may mean hub protection needs to be high on its rescue agenda.

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:

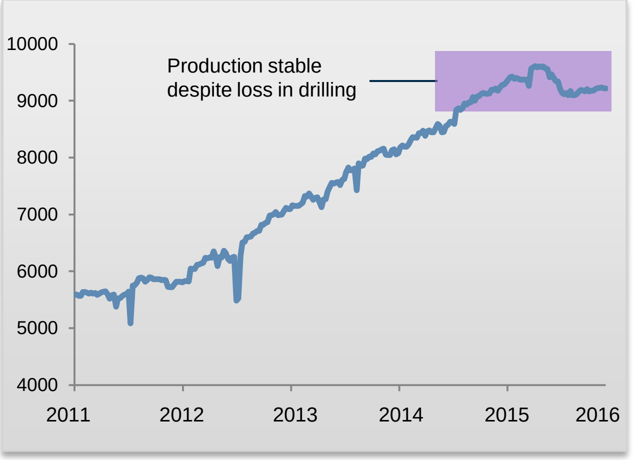
- Assisting companies pursue acquisitions, mergers or divestitures with financial and operational due diligence, valuation, tax structuring and acquisition/carve-out integration planning and execution.
- Working with management to optimise cost and CapEx, analyse asset performance and portfolio prioritisation,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



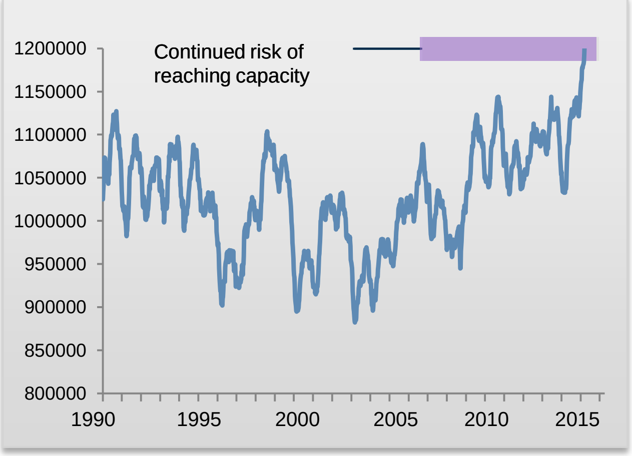
Source: EIA

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



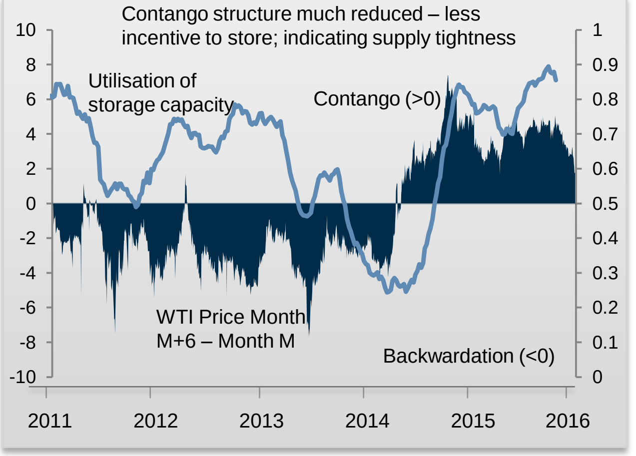
Source: EIA

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



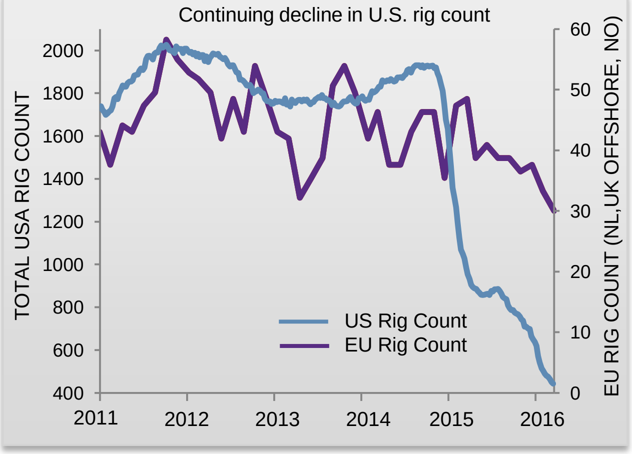
Source: EIA

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



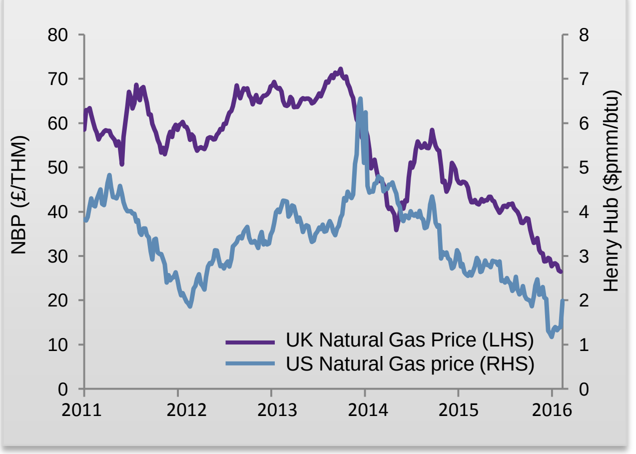
Source: Bloomberg, EIA

Rig Count



Source: Baker Hughes

Gas Price



Source: Quandi

* 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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