Think Ahead ACCA

Low prices, high expectations: Oil and gas CFOs in demand

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This report takes a closer look at how CFOs are tackling the big investment decisions: how they are adapting their funding strategies, how they balance short- and long-term priorities, and how they factor into their planning a range of shifting regulatory and market demands.

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Executive summary

Earlier this year, ACCA explored the priorities and challenges for CFOs in the oil and gas industry.

Earlier this year, ACCA explored the priorities and challenges for CFOs in the oil and gas industry. In this continued period of low oil prices, many of those challenges are magnified, creating a daunting to-do list for in the in-demand CFO.

This report takes a closer look at how CFOs are tackling the big investment decisions: how they are adapting their funding strategies, how they balance short- and long-term priorities, and how they factor into their planning a range of shifting regulatory and market demands.

With little clarity on when revenues will pick up again, CFOs need to be agile in how they re-scope or refine projects – and decisive in making short-term spending decisions for longer-term gain. Projects that are further advanced, with a limited time in which to succeed, will require a different strategy from newly initiated or projects or those still in the planning stage.

Whatever the size of company, or its acquisitive intentions, the need to cut costs is a given. It is the CFO's role to pick the best individual strategy or combination of strategies, while protecting key assets, core projects and expertise for when the upturn comes.

The industry's debt burden creates headaches of its own. With less confidence surrounding long-term price prospects, the lending picture is blurred. CFOs will need to seek non-traditional sources of funding, such as private equity, as well as expert advice from a potentially diminishing pool of financial specialists.

All these calls must be made amid ever-changing regulatory and fiscal pressures – global and local – and the biggest unknown of them all: the outcome of the December 2015 COP21 talks on sustainability and the impact of any climate change agreements.

The collaborative, creative CFO

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For CFOs in the oil and gas industry, borrowing the funds to finance all aspects of a company's operations, from large projects to the day-to-day activities, used to be routine. Now, however, it requires ingenuity, creativity and a willingness to take the lead in crucial business decisions. CFOs must plan investment and funding strategies by collaborating more with partners, at a time when no one is certain when revenues will pick up again.

Rob Van Velden is finance director of Sakhalin Energy, which is developing oil and gas reserves around Sakhalin Island in the Russian Far East. He maintains that although the current period is tough, it offers opportunities for the finance function to advance and take the lead.

'The intense, collaborative work that is required to come up with a robust cost-optimisation programme in response to the oil price slump offers opportunities for finance to get closer to the business in general. That benefits the overall effectiveness of the finance function in other areas too'.

Stewart MacDonald, CFO of UK-based Rockhopper Exploration, which has assets in the Falkland Islands and the Greater Mediterranean, agrees:

'My role, and I suspect it's the same for most CFOs of mid- and small-cap companies, is less about the preparation of accounts and more about transactions and financings. You need to make sure you have access to capital through equity and debt. That means much more engagement with shareholders and potential lending banks, taking them on the journey with you rather than keeping them at arm's length'.

CFOs must now consider a range of factors, from the impact of possible future interest rate rises on funding options to the fiscal frameworks for hydrocarbons investment. Another key consideration is the impact of global climate change policy on long-term demand, which could prove to be a bigger constraint than supply on investment in oil and gas projects (*see 'Climate change' panel*).

The long-term nature of much industry investment and activity calls for some crucial decisions. As Dr John Campbell, technical director of the International Association of Oil & Gas Producers, maintains:

'To make the right choices, we have to look decades ahead and take into account many different factors. This is why initiatives that bring more certainty, for example, in terms of regulatory frameworks – environmental, climate, fiscal and so on – in general provide help in guiding investment decisions'.

Some factors faced by CFOs also depend on the nature of the organisation. For example, the oil majors have typically invested in huge projects and programmes, heavily dependent on expensive innovations, which are often subject to cost overruns and delays. These companies must decide whether to push ahead with them or pull out – the latter also usually presenting a cost. Meanwhile, integrated oil companies – incorporating elements of upstream, midstream and downstream activities – are more diversified than smaller exploration and production (E&P) specialists and tend to be able to withstand low oil prices better: a low oil price may hit upstream sales to third parties, but it makes oil purchases cheaper for the refining division.

Project decisions: redefining revenue goals

Reduced income and uncertainty over the oil price outlook have led many firms to make short-term cuts in corporate spending.

Reduced income and uncertainty over the oil price outlook have led many firms to make short-term cuts in corporate spending. By the middle of 2015, developers had postponed final investment decisions on 45 upstream oil and gas projects, while cuts to exploration budgets for the year averaged around 30% (Rodger 2015).

Postponing projects that are just off the drawing board in hard times is often a

relatively straightforward decision. For example, it may be possible to hold back a planned multi-billion dollar deep-water drilling campaign and revive it when oil prices are higher and the economics make more sense. Rockhopper's Stewart MacDonald says:

> 'You need to balance the long-term strategic and value proposition with an increasing focus on short-term cash impact and liquidity in this sort of market'.

For Rockhopper and its partners, this has meant adapting its Sea Lion development off the Falkland Islands. Rockhopper made the Sea Lion discovery in 2010 and sold a 60% operating interest in the prospect and surrounding acreage to Premier Oil in 2012. MacDonald says:

> 'Previously we were looking at a full-phase development, which was going to cost in the order of \$4bn to \$5bn. We reacted to the change in the oil price by re-scaling the project, looking at a phased development with a view to minimising the up-front costs, pre-first oil. We're now focused on a leased FPSO [floating production, storage and offloading] concept, commercialising about 160m barrels, and with the pre-first oil capex estimate down to about \$1.8bn with scope for further savings'.

Projects that are further advanced, with a limited time in which to succeed, or where offtake contracts have already been signed, involve a different set of parameters. Despite falling gas prices, for example, the number of prospective multi-billion-dollar liquefied natural gas (LNG) export projects where a final investment decision (FID) is expected to be taken in 2015 and 2016, has not reduced significantly (Wood Mackenzie 2015a).

Some LNG projects may have a sounder financial footing because most of their output was pre-sold at a relatively high price in deals struck before hydrocarbons prices collapsed. But even if the gas has not all been pre-sold, a finance director may not feel that investing in such a project is a big risk, if he or she is convinced that gas prices will go up in a few years' time, given that the project had always been accounted for as a long-term revenue earner.

Some projects, if they are deemed to be of national importance, may be subject to political pressure. Increased competition in the world LNG market also plays a role. Delaying a project and missing out on market share later could be costlier to a company than tying up limited financial resources in the short term, even if that means scaling back investment in other areas of its business.

Short-term spending can be necessary – if money is available – to avoid bigger costs later on. For the band of small and medium-sized companies trying to develop increasingly marginal fields in the UK sector of the North Sea, time-sensitivity can influence whether or not they maintain investment in their assets there. They depend on the availability of ageing pipeline and processing infrastructure commissioned by their larger predecessors. Delays to production could render that infrastructure unusable.

30%

average cuts to exploration budgets for the year (Rodger 2015)

Gathering M&A momentum?

Lower revenues have led to a reduction in the market capitalisation of many upstream companies, leaving even some relatively large firms vulnerable to takeover.

41%

reduction in deals over $50 million

Lower revenues have led to a reduction in the market capitalisation of many upstream companies, leaving even some relatively large firms vulnerable to takeover, as demonstrated by Shell's $70bn-plus takeover bid for BG Group, made in April 2015. Earlier this year, ExxonMobil CEO Rex Tillerson said of his company's M&A ambitions:

> 'There really is no limitation on what we might be interested in and considering'.

Beyond the services sector and the Shell deal, however, merger activity among upstream companies has been limited. According to analytics firm Evaluate Energy, the number of deals relating to E&P companies that exceeded $100m in the second quarter of 2015 was 44% lower than the quarterly average in the three years to the end of 2014. The figure for deals over $50 million was down 41%.

This partly reflects the reluctance of companies with already stretched balance sheets to take on more assets that may produce only borderline profits at current oil prices. Some firms that have put themselves up for sale have struggled to find buyers, notably in the US shale sector.

With a consensus emerging in the industry that oil prices could pick up next year, the point at which M&A activity could increase may be approaching. Selected majors, large cap firms, national oil companies and private equity buyers could lead the way. Nonetheless, Colin Welsh of Simmons & Company International cautions:

> 'Things may well get worse before they get better. That will put pressure on over-leveraged companies, which is likely to drive some interesting consolidations'.

Industry analysts think it is unlikely that there will be a repeat of the wave of mergers among the top-level oil firms seen after the oil price falls of the mid-1980s, given the size of today's 'supermajors' and the strength of competition regulation.

The one area of the upstream oil and gas industry with notable M&A activity is oilfield services. Plummeting demand from E&P clients has triggered mergers and sell-offs across the sector, notably the mergers between Halliburton and Baker Hughes, and Schlumberger and Cameron. Schlumberger's $14.8bn offer for Cameron in August 2015 represented a 56.3% premium over Cameron's market capitalisation at the time of the announcement – demonstrating the value that market leaders place on their rivals while their share prices are depressed. According to Colin Welsh, the high premium paid by Schlumberger shows that the company has a bullish long-term view of the sector's prospects.

Sticking with the plan: keeping costs down

In-demand CFOs need to keep their options open: selling up, or postponing less profitable projects are both possibilities being tried by firms across the sector.

In-demand CFOs need to keep their options open: selling up, or postponing less profitable projects are both possibilities being tried by firms across the sector. Some companies may adopt a strategy based on asset sales, while better-funded rivals follow one based on opportunistic asset purchases. Many are doing both at the same time, building up core assets while divesting peripheral activities. Even acquisitive companies are generally stripping back their businesses to focus on core activities. That applies to the small and mid-caps and the big players – including Royal Dutch Shell, which is planning to sell off $30bn of assets between 2016 and 2018 (Reuters 2015).

$30bn

of Royal Dutch Shell assets to be sold off between 2016 and 2018 (Reuters 2015)

That said, no upstream leader wants to sell off prized assets or abandon projects that could restore the company's fortunes when oil prices pick up. According to Rob Van Velden:

> 'While Sakhalin Energy is taking costs out, the longer-term view on oil prices has changed somewhat but nothing dramatic, therefore most of our long-term investments remain profitable and stay in the plan as before'.

So to ensure that core investments have longer-term returns when cash flow is constrained, CFOs have been pushing for short-term costs to be driven down – and in some parts of the sector this is producing results. Those developing the increasingly mature – and in some cases marginal – UK North Sea oilfields have suffered heavily from low oil prices, but the industry has responded with large cost reductions. Oil & Gas UK, which represents the country's upstream industry, estimates that, by the end of 2016, improved efficiency across the sector will lead to a fall of more than £2bn, or 22%, in the cost of operating existing assets. Along with the first annual production rise for 15 years, this is improving the unit cost of operating UK oil and gas assets.

One key area for cost cutting has been substantial redundancies in both E&P (exploration and production) and oilfield services firms. Between the start of 2014 and August 2015 the number of jobs supported by direct, supply chain and indirect employment related to the UK offshore industry fell by 15% to 375,000, according to Oil & Gas UK. Its economics and commercial director, Mike Tholen, adds:

> 'In 2008, when the oil price wobbled, the industry had enough confidence in a price recovery that, while they needed to reduce costs, they were not focused on redundancies. Now the challenge for both the industry and government is to find a way to maintain confidence, so that we retain enough resources to be able to access the upside when it comes'.

The oilfield services sector has been particularly hard hit, globally and in the North Sea, as overcapacity has led to reduced rates for equipment and services, and to substantial lay-offs. These difficulties have led to a shake-up in the sector, prompting major mergers, such as that between Schlumberger and Cameron, discussed above.

Finding funding in difficult times

CFOs, already operating in a world of tighter lending limits following the 2008 financial crisis, are now contending with continued low oil prices.

CFOs, already operating in a world of tighter lending limits following the 2008 financial crisis, are now contending with continued low oil prices. Alongside reduced cash flow, this also means that, for some companies, the prospective future earnings – against which lenders will assess their worth – have fallen by perhaps one-half in the course of just a few months. More immediately, CFOs of some companies face the issue of how to tackle their existing debt, which is proving a challenge to service in an era of lower revenues from hydrocarbons sales.

$550bn

is due for repayment over the next five years

The industry's debt repayments will increase for the rest of the decade, with $72bn maturing this year. This will rise to $129bn in 2017, so $550bn is due for repayment over the next five years. Of debt due this year, US drillers account for 20%, Chinese companies 12% and those from the UK 9% (Katakey and Casiraghi 2015). All this means that while oil prices remain depressed, bankruptcies and distress sales are likely to be a feature of the industry.

John Mitchell, an associate research fellow at Chatham House, and a former BP executive, says that, aside from cash flow, the sector faces two issues.

- Raising funds from long-term bonds when interest rates are generally low is advantageous, but a low interest rate environment may not last. As Mitchell points out:

  'This raises the question: how much do you want to load up your company with debt?'

- Long-term price prospects are no longer the ever-ascending 'golden staircase' they once seemed to be. In the short term, prices are restricted by surplus production and weak demand, complicated by China's economic malaise. In the medium-term, demand is likely to be restricted by other factors, such as the rate of uptake for renewable energy and alternatives to oil for transport, improvements in energy efficiency and the requirements of climate change policies (*see 'Climate change' panel*).

The impact of higher interest rates in key lending markets in the coming years may exceed just pushing up the cost of borrowing. Rising rates may also make other lower-risk sectors – where returns are traditionally less eye-catching than those in the oil business – look more attractive to investors. In particular, it may make private-sector financing for high-risk, high-return oil and gas projects in some developing countries harder to obtain, unless terms are improved to make yields match those available for investors elsewhere.

Firms with promising acreage in a developing country would typically hope to draw in substantial investment – and expertise – from large partners, but those potential partners have scaled back their interest in some regions because of their spending constraints. Some licence holders with gas-rich acreage off Mozambique, for example, have struggled to find investors to take equity stakes in their projects in recent months.

New funding: turning to private equity

Of course, the impact of these factors on upstream firms' ability to raise money is not uniform.

30%

reduction in US high-yield debt and share sales on June 2015 levels by mid-August (Driver and Wade 2015)

Of course, the impact of these factors on upstream firms' ability to raise money is not uniform. On one hand, a pioneering small-cap firm drilling for oil on virgin acreage in sub-Saharan Africa carries high operational and political risk, and requires a high oil price to break even. On the other, a small driller in a well established US shale market, where the breakeven oil price is lower and the time between sinking the drill bit and first returns is usually much shorter, would have been able to rely on equity market investment and high-yield bond funding from comparatively liquid US domestic capital markets in the first part of 2015.

This access to funding, together with technological improvements that have enabled drillers to eke more out of their existing wells, enabled US drillers to weather the storm of early 2015 better than many had expected. Later in the year, however, there were signs that, even in the US, funding patterns were changing, as hopes dimmed of an end to oversupply of oil in world markets and an early recovery in oil prices. According to Reuters, US high-yield debt and share sales in the first half of 2015 totalled $44bn, but slowed rapidly in the latter part of the year, and were already 30% down on June 2015 levels by mid-August (Driver and Wade 2015).

As confidence drains from traditional funding sources, experienced private equity firms, prepared to take on higher-risk investments with longer payback times, are stepping into the breach. Private equity, already an important source of financing for the industry since the 2008 global financial crisis made funding harder to come by, is expected to play a greater role in future.

Colin Welsh, CEO of investment bank Simmons & Company International says:

> 'It is impossible to predict the near-term profitability of any oil service company just now, so that makes deal pricing difficult. The generalist investors are very nervous when the industry is in a prolonged downturn, but for specialist private equity investors who understand the cycle, and know that the industry will recover, low oil prices represent an opportunity'.

Until crude prices recover and activity picks up, oil service companies will be under significant pressure, especially those that are highly levered, he argues. For experienced oilfield investors who have faith that it is only a matter of time before the sector bounces back, the next 12 months will be ripe with opportunities for acquiring quality businesses at prices that, in time, will look cheap.

Nonetheless, as companies' need for expert advice on fresh funding avenues grows, another challenge looms. Several large lending institutions have reduced or even eliminated their oil and gas teams – along with those in other sectors – over the years since 2008, potentially leading to a lack of expertise and understanding of funding issues.

David Messina of Hutton Energy says this could be a concern in the long term:

> 'Banks have definitely got smaller oil and gas teams than they might have had 18 months ago. If what you are proposing is not straightforward, there can be frustration, because you need a depth of knowledge'.

FUNDING WITH DEVALUED ASSETS

Tullow Oil, an independent producer, was regarded as highly successful when prices were high, but struggled to maintain revenues during the price slump. Nevertheless, it still managed to secure funding to see it through the downturn.

The much-reduced earnings potential of Tullow's existing reserves – many of which are in Africa, where the company concentrates its activities – severely reduced the scope of reserve-based lending (RBL) and hit the company's bottom line, contributing to its first full-year loss for 15 years, in 2014. In January 2015 the company wrote off $2.3bn, suffering from the combined effects of the low oil price and a string of non-commercial wells in French Guyana, Mauritania and Norway.

Despite this, Tullow still managed to announce crucial extra lending in March 2015. This included a $200m increase in RBL to $3.7bn, as well as an extra $250m via its corporate credit facility, raising that source to $1bn. These agreements brought the company's total committed debt facilities to $6.3bn.

For the time being, Tullow is focusing on its producing assets, mainly in West Africa, as well as developing the already well-advanced TEN offshore oil and gas project in Ghana. For the bankers, the company's decision to focus on producing assets with guaranteed returns, while waiting for the reappearance of better times, was judged to be a much better option than letting it slide into further financial difficulties.

Getting back on track: the role of government

Despite the multifaceted challenges, the CFO does have cause for some optimism.

Despite the multifaceted challenges, the CFO does have cause for some optimism. Analysts believe the lower costs now prevailing could be attractive enough to trigger a rise in drilling activity in 2016. Companies are also eager to obtain better fiscal terms from the countries in which they are investing. In general, oil firms say fiscal terms have not improved significantly in many oil-producing countries since oil prices started to slide.

David Messina, managing director of UK-based Hutton Energy says:

> 'That's an area which could have a very positive impact. You could very quickly improve investment opportunities by getting some further relief through better terms, which could be linked to the oil price. But we are still not seeing anything concrete from governments yet'.

In the UK North Sea, firms are calling for lower taxes. That call was partly answered in the 2015 budget, in which the government effectively removed taxes that were imposed on the sector in 2011, at a time when oil prices were higher and companies were keen to extend the life of mature fields.

That has still not stopped today's reduced revenues having a profound effect on investment. Wood Mackenzie estimates that 140 fields on the UK continental shelf will cease operations over the next five years, even if oil prices rise to $85 per barrel. If the oil price only climbs to $70 per barrel, it maintains, some 50 fields will stop production earlier than intended. This compares with just 38 new fields expected to be brought on stream in the same time (Wood Mackenzie 2015b).

Oil and gas firms and their lenders may also find it harder to invest in the oil and gas sector of some developing countries, unless governments in those countries make their oil and gas operations more transparent. Regulatory requirements and frameworks that are being more widely adopted – such as the Extractive Industries Transparency Initiative (EITI) – require all parties to be more transparent in hedging, the nature of payments to governments or contractors, and how contracts are awarded.

This call for clarity comes as geopolitical shifts challenge accepted thinking. Now that the US can supply 90% of its energy needs from domestic sources (up from 70% in 2005) (Giles 2014), while Russia continues to pursue interests in China and India, and OPEC's power is called into question, the CFO must re-imagine what the future may hold.

90%

of the US energy needs can be supplied from domestic sources

CLIMATE CHANGE POLICY: A MAJOR IMPACT ON DEMAND

One important factor affecting investment decisions is the potential for concerted global action – or lack of it – to fight climate change. Oil and gas firms remain unclear about the extent to which future measures to curb global warming will affect medium- to long-term demand for fossil fuels. This is impeding their investment planning.

In the absence of policy frameworks, companies risk either investing too much or too little in fresh oil supplies, depending on how climate change policy develops. This is set out in a recent report by UK think tank Chatham House, co-written by John Mitchell, a former BP executive. (Chatham House, 2015)

Also, while investment in gas production may look a like a solid prospect, given the role of gas as a bridging fuel for the power sector as it moves to greater use of renewable energy, CFOs cannot necessarily treat the sector as a guaranteed revenue stream. Aside from factors such as the high costs of LNG production and transportation, gas demand also depends heavily on governments' domestic power supply policies. In addition, gas is not necessarily a priority fuel, despite its relatively low carbon emissions compared with other fossil fuels.

That point has been well demonstrated in Germany. There, cheap coal and imports of electricity have played a larger role than gas in filling the gap after the country's nuclear power programme was abandoned. This has been despite the country's avowed commitment to meeting EU emissions targets.

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