ENERGY INVESTMENT BANKING

MUSINGS FROM THE OIL PATCH

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Note: *Musings from the Oil Patch reflects an eclectic collection of stories and analyses dealing with issues and developments within the energy industry that I feel have potentially significant implications for executives operating and planning for the future. The newsletter is published every two weeks, but periodically events and travel may alter that schedule. As always, I welcome your comments and observations.* Allen Brooks

Entering A New Phase For Oil Company Business Strategies

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The oil industry was shocked by the recent announcement of BP plc (BP-NYSE) selling its Alaskan assets to Hilcorp Alaska, a subsidiary of privately-owned Hilcorp Energy Co. of Houston, for $5.6 billion. The deal includes BP's stakes in the Prudhoe Bay field, the 800-mile trans-Alaska pipeline, the Point Thomson and Milne Point fields, and leases in the Arctic National Wildlife Refuge, on land owned by an Alaska Native village corporation. Not included in the transaction is BP's oceangoing tankers that move crude oil from Alaska, although the parties are reportedly discussing them.

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BP has been involved in Alaska since 1959 in response to the 1955 Middle East oil crisis that exposed the company's vulnerability to total dependency on that region for its oil supply. BP moved into Alaska, with the backing of its UK government owners, via a joint venture with U.S. independent Sinclair Oil and drilled six expensive wells on the North Slope that were dry, before abandoning the effort.

Over the years, as the global oil industry consolidated, BP acquired many of the key players involved in the discovery and development of the North Slope's Prudhoe Bay oil field, ranked by consultant DeGoyler and McNaughton as the largest oil field ever discovered in North America, one-and-a-half times larger than the East Texas field found by wildcatter Dad Joiner in the early 1930s.

BP has been reducing its Alaskan presence in recent years. It sold two fields to Hilcorp in 2014, along with portions of two other fields. In 2018, the company sold its interest in the Kuparuk field to ConocoPhillips (COP-NYSE). Through these transactions, BP's oil production has dropped from 125,000 barrels per day (b/d) in 2014 to an estimated 74,000 b/d this year.

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It is interesting that earlier this year BP conducted the first-ever three-dimensional seismic shoot over the entire Prudhoe Bay field, seeking hidden pockets of oil. That was part of the company's plan for the long-term. The plan was referenced in an email to employees announcing the sale from BP Alaska President Janet Weiss. She wrote, "Saying goodbye won't be easy, but we can all be very proud of how we have set the field up for 40 More (years) as a new chapter begins for Prudhoe." That is a significant statement given Hilcorp's record of bringing new life to mature fields.

The ownership transition requires a psychological adjustment by Alaskans as well as BP employees, which was pointed out by Larry Persily, a former federal gas official for Alaska. North Slope oil production today is about a quarter of its peak output of two million barrels per day in the 1980s. As he put it, "BP has been here since the dawn of time. For some people it's a smack in the head that the North Slope is in decline."

After almost 50 years in the region, ExxonMobil now only accounts for about 5% of UK's oil and gas output

Rumors are that Exxon Mobil Corp. (XOM-NYSE) is considering selling its Alaskan interests, also. That would come following the announcement the company is contemplating selling its UK assets for potentially £1.6 ($1.9) billion. After almost 50 years in the region, ExxonMobil now only accounts for about 5% of UK's oil and gas output from 40 fields, including the iconic Brent field, brought into production in the 1970s. The assets are part of a joint venture operated by Royal Dutch Shell (RDS.A-NYSE) begun in the 1960s. ExxonMobil has indicated an agreement to sell its Norwegian assets for roughly $4 billion, ending a decades-long history in the country.

ExxonMobil's contemplated North Sea sale would mark the third major oil company to depart this year. In April, ConocoPhillips sold its assets to Aberdeen-based Chrysaor for $2.67 billion. Two years earlier, the independent had bought Shell's North Sea assets for $3.8 billion. In May, Chevron Corp. (CVX-NYSE) sold its assets to Israeli-owned Ithaca Energy for $2 billion. One outcome of these sales is a dramatic shift in who are the leading producers in the North Sea now, and the outlook for spending in the basin.

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Indications are that much of the cash raised in these sales is targeted for shale developments. The key deciding factors is likely the abandonment liabilities of North Sea assets. ExxonMobil's UK liability is estimated at $1.5 billion against an estimated sale value of $1.6 billion. Increasing investment in shale assets is another question, but it is reserved for another time.

Exhibit 18. Production Is Changing Even More In 2019

TABLE 1 Leading North Sea producers in 2018 (bd)

CNOOC	235 000
Chrysaor	120 000
Total	179 000
Shell	120 000[a]
BP	100 000[a]
ConocoPhilips	75 000
Chevron	50 000
Enquest	56 000 (boe)

[a]Estimate. Not an exclusive list.
Source: Various.

Source: Oil and Industry Trends

Smaller, nimbler E&P companies, often backed by private equity have entered with a goal of maximizing the remaining reserves and resources

Another North Sea sale was Total's (TOT-NYSE) sale of several fields and interests in others to Petrogas for $635 million. These assets were acquired as part of Total's 2017 purchase of Maersk Oil. As more of the long-term players, who pioneered and grew the North Sea into a significant oil and gas exploration and production basin, exit, smaller, nimbler E&P companies, often backed by private equity have entered with a goal of maximizing the remaining reserves and resources.

Exhibit 19. North Sea Ownership Change Boosts Capex [Blurry]

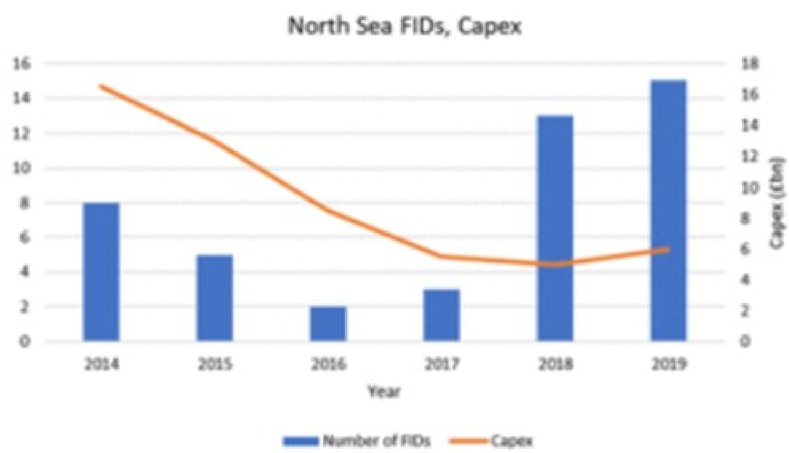


FIGURE 3 FIDs and Capex. Average project size down sharply since 2014; more projects for less money. *Source:* Oil & Gas UK, S&P Platts; 2019 estimated

Source: Oil and Industry Trends

The first couple of years after OPEC's decision were spent downsizing operations, including ending long-term contracts,

disposing of easily-sold assets, shoring-up balance sheets, and determining where the industry's future growth lay

What we are witnessing is the next phase of oil and gas companies reorienting business models in response to the new era ushered in by the 2014 oil price crash. As we approach five years since the infamous Thanksgiving Day OPEC meeting at which oil pricing was tossed to the winds, the major oil companies are evolving new business strategies. While some might question why it took so long for this to happen, the reality is that turning "ocean liners" takes time and room. The first couple of years after OPEC's decision were spent downsizing operations, including ending long-term contracts, disposing of easily-sold assets, shoring-up balance sheets, and determining where the industry's future growth lay. There have been other significant industry moves, as well as senior management changes, all driven by the need to adjust business strategies. Below the surface is the growing round of E&P bankruptcies, although most of them today involve reorganizations and not liquidations, although the companies' new owners may be very willing to capitalize on sales and/or mergers.

The company's focus going forward will be to invest in low-breakeven projects that can weather weak oil prices

Total CEO Patrick Pouyanne pointed to continuing volatility in markets as the reason for his company's reassessment. By the time of Total's North Sea asset sale announcement, Brent had averaged $69 a barrel in 2Q2019, but natural gas prices were down 36% in Europe and 26% in Asia. The deal came only months after crude oil's volatile 4Q2018 price action.

As part of Total's new strategy, it plans to sell $5 billion of assets (including the recent sale), with $3 billion coming from the company's upstream operations. It is targeting assets that can only break even at high oil and gas prices. The company's focus going forward will be to invest in low-breakeven projects that can weather weak oil prices. At the same time, it will continue expanding in natural gas and electricity, with a particular focus on its core strengths in natural gas and deepwater. The company's governing philosophy is to consider projects with an organic pre-dividend breakeven below $25 a barrel, while the organic post-dividend breakeven (allowing Total to pay dividends and continue making investments) is below $50 a barrel. Is this the epitome of "lower for longer?"

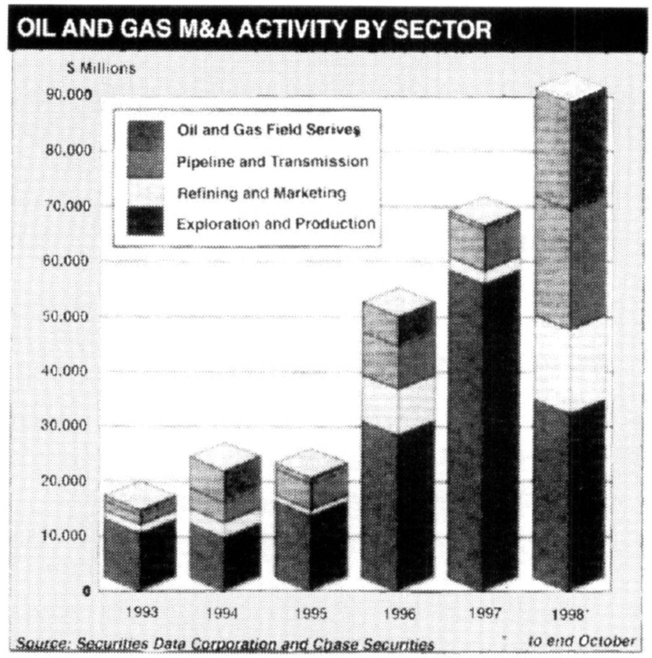
Before it is over, the changes may resemble how the merger mania of 1997-2001 altered it

We are likely in an early phase of restructuring the global oil and gas industry. Before it is over, the changes may resemble how the merger mania of 1997-2001 altered it. That was when BP acquired Amoco and ARCO, Exxon merged with Mobil Oil, French oil companies TotalFina and Elf ended their takeover struggles and merged, as well as Chevron purchasing Texaco. And that was only at the top end of the industry food chain.

All of this M&A activity came as oil prices were finally recovering from the mid-1980s collapse in their eventual march to nearly $150 per barrel in a matter of five years!

Change in the oil patch has been a constant since its founding, as new players enter and existing ones exit. The magnitude of merger and acquisition activity in the oil and gas sector in the latter part of the 1990s is shown in Exhibit 20 (next page). The chart doesn't reflect the $27 billion BP/ARCO deal, nor the $39.5 billion Chevron/Texaco transaction done after 2000. In 2002, Conoco and Phillips merged in an $18 billion deal to form ConocoPhillips, and three years later, it purchased Burlington Resources for $33.8 billion. All of this M&A activity came as oil prices were finally recovering from the mid-1980s collapse in their eventual march to nearly $150 per barrel in a matter of five years!

Exhibit 20. Oil & Gas M&A Soared At End of 1990s



Source: ***SAGE Journals***

Unknown is how important natural gas will become, as well as renewables and electricity

At this point, no one knows who and how many energy companies will be involved in the industry's restructuring activity, or exactly how the industry will look in the future. What we can say is that no industry segment will be untouched by change. Areas of the business once thought to have bright futures may be dulled. Unknown is how important natural gas will become, as well as renewables and electricity. All of them will be more significant in the oil company of the future. As painful as the transition may prove, it may lead to a more profitable business. Bigger is not always better, but greater profitability is always rewarded.

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