Hannon Westwood

North Sea Update Newsletter
May 2009

A message from Charles Westwood, Chairman:

It is trite to say that the impact of the “credit crunch” and lower product prices in the North Sea E&P scene is likely to be radical. Although the budget gave welcome relief to small, ultra heavy oil and ultra HP/HT fields, no direct incentives were offered to encourage UKCS exploration drilling.

The North Sea oil industry has successfully adapted to the prevailing financial environment many times in the last 30 years. I expect this to happen again and again as the remaining reserves are too valuable to the UK to be ignored.

For some companies this will be a period for opportunistic acquisition, for others it will necessitate rationalisation.

I hope you find this newsletter of interest.

Charles Westwood

UKCS Drilling Activity

In 2008 the UK sector saw the highest level of exploration and appraisal (E&A) drilling for ten years. Excluding sidetracks, 77 spuds covered 44 exploration wells and 33 appraisal wells, only marginally below the 1997 total of 80 wells. Additionally, eight exploration sidetracks and 28 appraisal sidetracks commenced during the year. At 43% of activity, the relatively high proportion of appraisal wells demonstrated a continuing shift towards commercialising existing discoveries.

At the beginning of 2009, 15 E&A wells were active in the UK sector, utilising 12 rigs, one drillship and two platforms. This has since reduced to ten mobile units and one platform rig active as at end Q1, still predominantly appraisal. The long-running nature of some current wells is maintaining the active rig fleet for the time being.

The Hannon Westwood planned well database currently contains around 200 forthcoming wells, predominantly exploration, and there is evidence of rig and vessel day rates dropping. It is clear that the UKCS sector continues to produce potentially commercial finds and the process of rapidly moving from exploration through appraisal to development appears to be becoming more efficient.

The widely predicted continued consolidation in the sector could either threaten drilling activity or, conversely, cause wells to be reinstated following the acquisition of underfunded portfolios by larger, more financially robust, companies.

Consolidation in the Sector

As regularly quoted in the media, Hannon Westwood records show that of the present 168 UKCS licensees, 99 have no production; frequently we have stressed that consolidation within the sector is long overdue. The question is – have recent events created any belief that some major consolidation is now likely?

Hannon Westwood has reported on the following recent deals:

Suncor/Petro-Canada: this is a step reminiscent of the mega-mergers which resulted from the oil price crash of 1997/98; two complementary businesses seek alignment to deliver economy of scale; value can be added by integrating similar cultures and divesting non-core business units.
Premier/Oilexco NS: here Premier takes advantage of the double-whammy that hit a bullish, successful new entrant; the combination of oil price drop and very restricted financing leaves a strong portfolio available to a cash-rich, but UK opportunity-poor, established player.
Dana/Bow Valley: Dana has moved opportunistically to purchase Bow Valley in a US$177million (including debt) deal; the relatively modest UKCS assets will contribute to a balancing of Dana's UKCS production base with its higher risk West African properties.

Each of the above represents 'business as usual' for the acquirer, as will any future purchase of Venture (or similar target) by Centrica (or similar predator). Any business shortcoming that leaves a player exposed to tougher trading conditions will create an opportunity to be exploited by the better placed. As has now happened for Oranje-Nassau, exits will happen when the right buyer emerges, or reasonable terms can be reached.

But will the raft of small companies suddenly self-destruct? There will be as many answers as there are business models. The 'traditional', privately-funded, independent may still survive – building large equities in quality prospects to farm-down and stay, or sell, when the time is right. Companies which have taken advantage of unexpectedly easy bank funding in the recent past will struggle when credit has to be renewed – even if there is a dramatic decline in the cost base. But the real puzzle will be for the AIM-listed players; with stock prices bumping along at rock-bottom, no premium will be offered in a flatter oil price environment yet why would investors sell out at a loss when doing nothing seems to be an option? Time is providing the real pressure here with tighter restrictions on the length of time the prize quality assets can be held before the owners are forced to attempt to commercialise them or risk having taken back for recycling by government.

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2009 Budget

In preparation for the 2009 Budget, Hannon Westwood has worked with OGUK to analyse which fiscal incentives might be offered by Treasury to encourage the development of 'difficult' discoveries. It was the remit of the study that any 'value allowance' which might be made available would be revenue neutral to the economy – any tax reliefs to be given had to be demonstrably capable of being offset by the revenues which might not otherwise be generated. On this project HW created a 'fiscal model' through which were run all 413 undeveloped discoveries in its database. Difficult discoveries were divided into classifications – small fields, heavy oil, HPHT, West of Shetland and tight gas.

The 22 April Budget announced that a 'Field Allowance' will be introduced that will offset, for a defined period, the supplementary corporation tax which would have been chargeable. The Field Allowance will apply to fields given development consent after 22 April where the fields are (a) ***small*** – defined as up to 25 mmboe reserve (with a sliding scale applying between 20 mmboe and 25 mmboe); (b) ***heavy oil*** – where oil quality is less than 18 deg API and with a viscosity of more than 50 centipoise; and (c) ***HPHT*** fields with a temperature of more than 176.67 degrees Celsius (315 degrees Fahrenheit) and pressure of more than 1,034 bar (15,100 psi) in the reservoir formation.

In addition to the Field Allowance, the Treasury will free asset swaps (and some other transactions where proceeds of disposal are re-invested) from Capital Gains Tax liability and also allow decommissioning liabilities to receive PRT relief after the expiry of the relevant licence.

We see in these provisions that Treasury officials are taking guidance from DECC in its continued drive to get assets into the right hands. Having greatly encouraged exploration activity in the recent past, Government, through these Budget measures, will go some way towards removing barriers to the exploitation of more difficult accumulations. Whether enough has been done to unblock the issues impacting the commercialisation of such discoveries remains to be seen.

The removal of CGT from asset trades should also facilitate swaps of producing interests driven by the search for cost effectiveness. This should encourage more companies to seek sophisticated asset trades such as that recently negotiated between BP and BG; it is notable that deals like that are generally resilient to the fluctuations of commodity prices.

About Hannon Westwood

A respected advisor to the upstream UKCS environment since 1993, Hannon Westwood offers a wide range of acreage intelligence and bespoke consultancy services. In an environment where rapid market access and effective growth strategies are crucial, Hannon Westwood clients benefit