

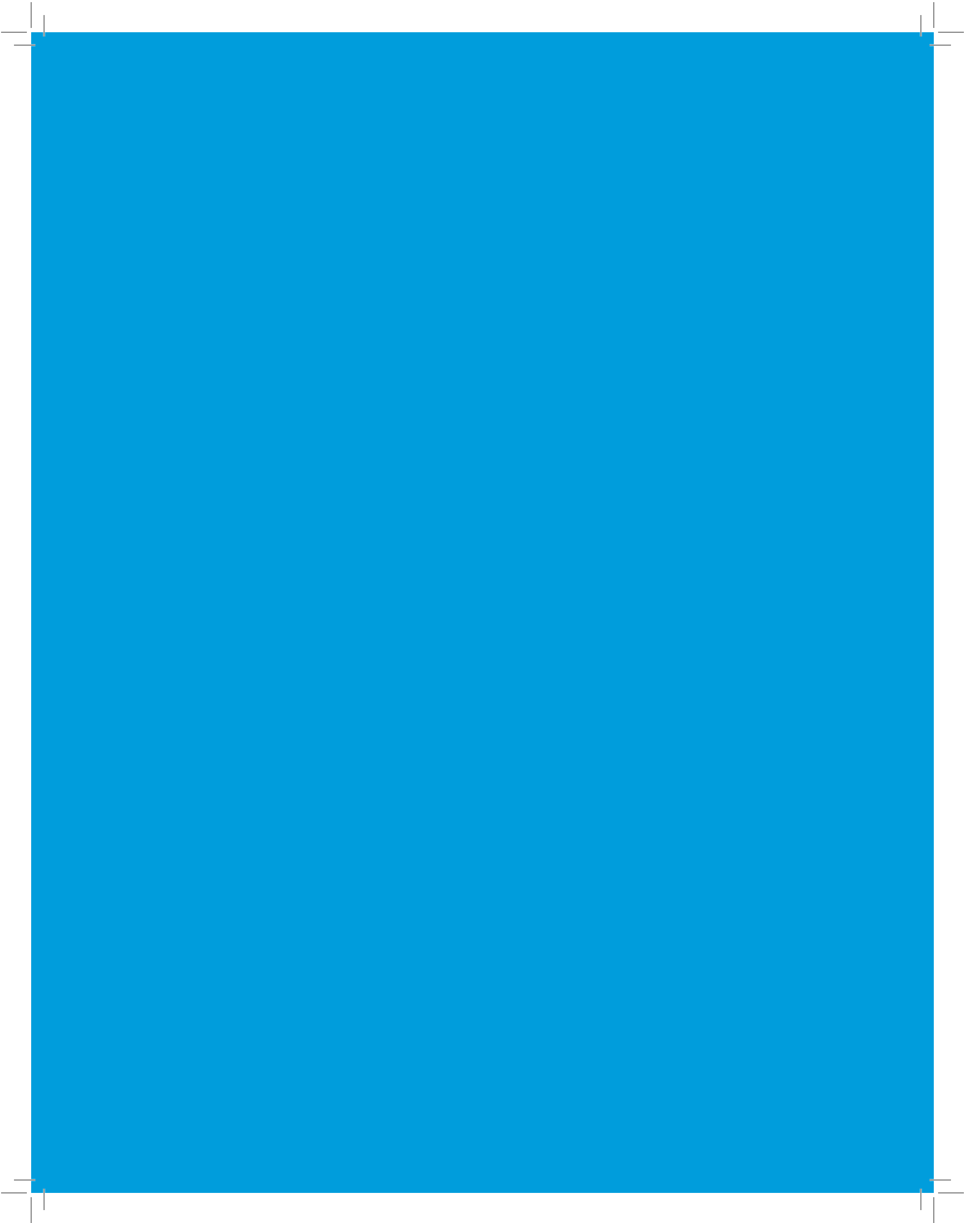


Are Oil Companies Poised to Increase Investment, Including a Ramp-Up in M&A Activity?

By Rick Roberge, Transaction Services Partner
PricewaterhouseCoopers

(Article featured in
Oil & Gas Financial Journal, July 2005)

PRICEWATERHOUSECOOPERS 



Are Oil Companies Poised to Increase Investment Including a Ramp-Up in M&A Activity?



By Rick Roberge,
Transaction Services Partner,
PricewaterhouseCoopers

As the first quarter of the year concludes, the operating results for 2004 are in and not surprisingly, they reveal operating cash flow levels.

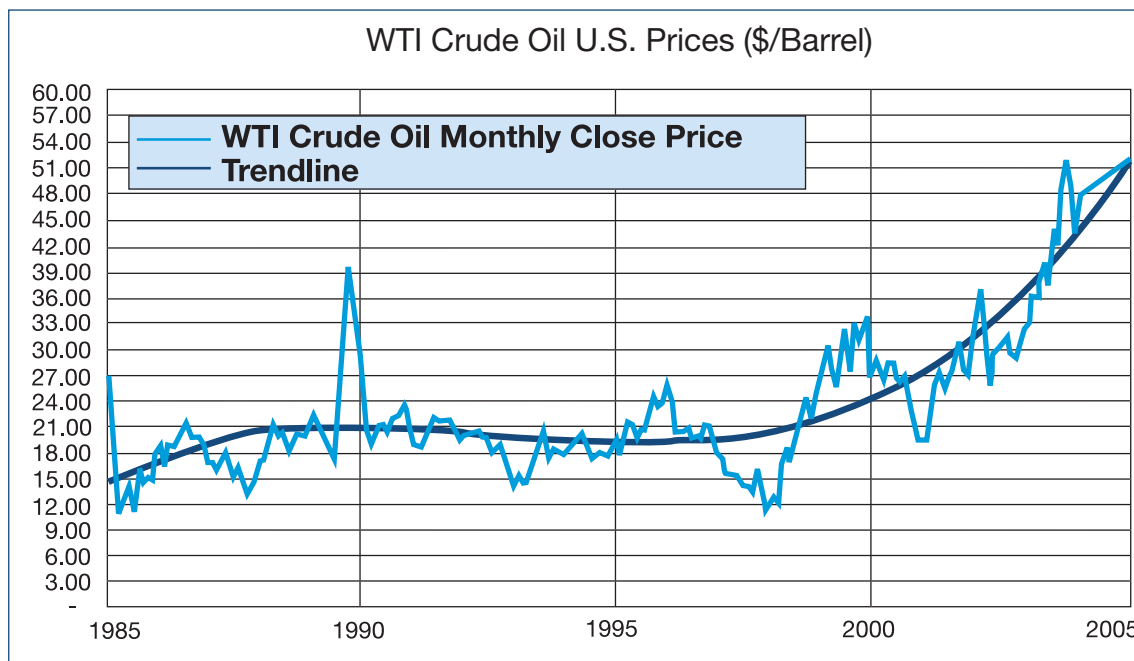
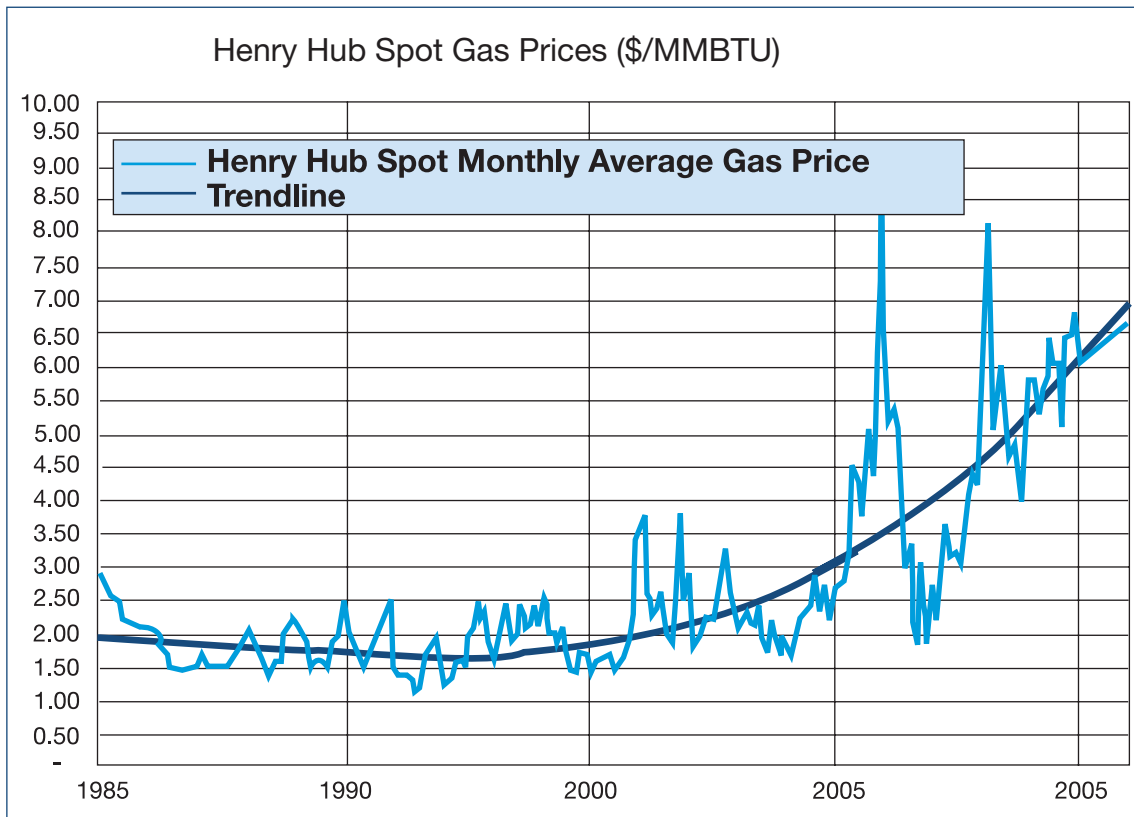
First quarter '05 results confirmed the trend in fiscal 2004, as record high commodity prices continue. Yet, what also follows these results is another round of increased stock buy-back announcements by many of the companies. When will oil companies begin to increase investment levels commensurate with their cash flow increases? Is there a continuing lack of opportunities, even at these commodity prices, to earn acceptable rates of return? Or do they simply believe that these commodity prices are destined to fall? Will they revert to the M&A markets to replace reserves? Answers to these and other questions will likely begin to unfold in 2005.

What we already know is that worldwide demand for energy continues to rise. Crude oil demand is expected to reach 84 million barrels/day in 2005, and is forecasted to reach 120 million barrels/day by 2030. The capital investment required to meet this demand is estimated at a staggering \$4 trillion, or \$160

billion/year according to the International Energy Agency. On the Natural Gas side, North American consumption is expected to rise 36% between now and 2020 according to the U.S. Department of Energy while gas production in North America, given current decline rates, is unlikely to grow over this period. Given this set of facts, why do the International oil companies (IOC's) seem to be resisting a ramp up in investment activity?

To understand the companies' current strategies, let us review the past reaction of companies during previous commodity price spikes and then examine current levels of cash flow investment over the past two fiscal years, and discuss why companies' reaction during this cycle appears to be different than previous cycles.

There is no question that the current cautious investment behavior we are witnessing is a reflection of what has happened in the past. During previous "mini-booms" characterized by significant



commodity price spikes, oil companies ramped up spending and, in many cases, drilled marginal or very high risk projects driven on economics that were too optimistic. In addition, M&A activity would increase significantly and per BOE asset prices would rise accordingly. Inevitably, prices would fall and large asset write-downs would be

the consequence, resulting in significant stock punishment by Wall Street. As a result, shareholder returns in the oil industry (by any measure) have been below par for the past 20 years and it's the investment reaction during the boom times that has contributed to the shortfall. With that as a backdrop, it's not surprising that this time a more

cautious investment approach has driven the company strategies.

Ultimately, increased investment is going to depend in part on whether companies believe these current commodity price levels are more permanent than temporary. First, with respect to natural gas, industry executives appear to be becoming more comfortable with a new North American natural gas pricing environment and the resulting LNG projects on the table are a testament to that (See Natural Gas price graph below). LNG projects are highly capital intensive, but those major dollars will be spent in 3-5 years time. Current projections have total global LNG spending totaling \$65-\$70 billion from 2005-2009. That compares with approximately \$20 billion spent the past five years.

With respect to crude oil, it appears there is still an overall concern that all price spikes eventually come back to \$20 (See oil price graph, previous page). However, the last 5 years represents the longest ever sustained run-up over \$20. That aside, the IOCs likely continue to use \$20-\$25 oil prices to run their long-term project economics. However, the longer crude stays high, the more the industry is likely to begin to feel more comfortable with a higher crude oil band and perhaps a permanent structural change in the oil markets. Certainly, OPEC has recently been sending signals that it's more comfortable with a higher band, as the previous \$22-\$28 price band is all but history. Given these dynamics, will the IOCs begin to move the bar on project economics to \$30, and would this drastically increase their spending?

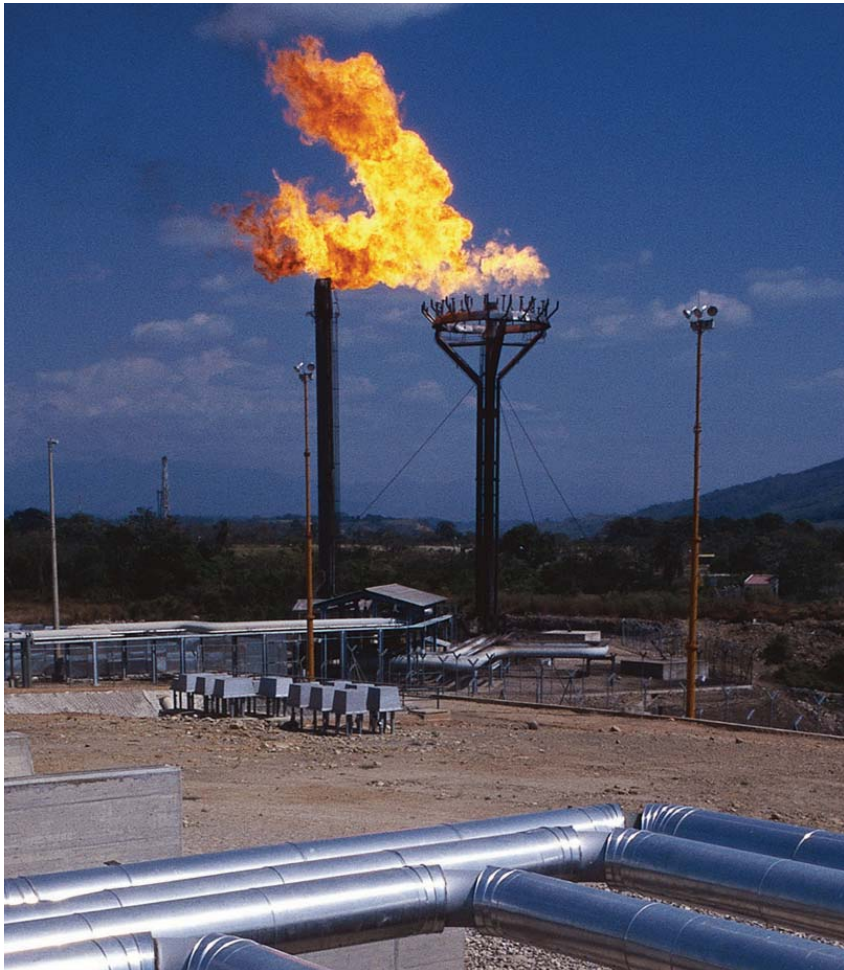
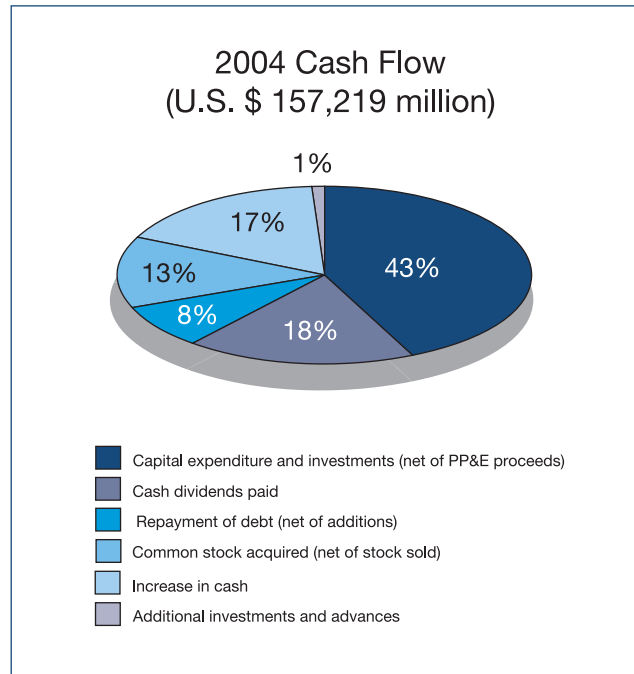
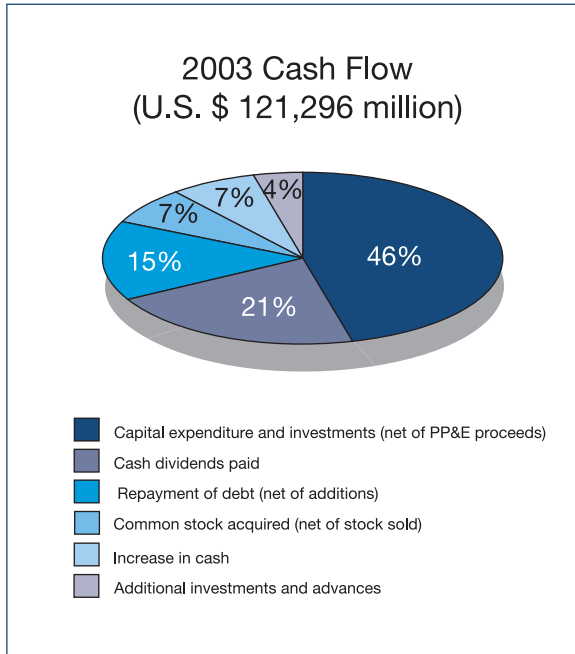
It sure looks that way. Hydrocarbons are becoming more and more difficult to find (especially major fields) and produce at acceptable returns. This is due to a number of factors. One is geology and the maturity of the IOC's OECD base territory, which combined with rising oil service costs is starting to push reserve replacement rates down and F&D costs up. In what might be an ominous trend all the five IOCs in our study reported less than 100% SEC-definition reserve replacement for 2004. In addition, many new studies have been recently released showing North American F&D costs up over \$10 per BOE. In addition to reserves becoming harder and more costly to find there are political barriers to quality projects. There is a growing tendency among host governments to impose or threaten punitive fiscal measures when the



oil price is high (witness Russia, Venezuela, Trinidad and Bolivia this year). Finally, another obstacle which could hinder access to quality projects, is the appetite of the National Oil Companies, (NOCs)—which apparently are driven more by security-of-supply concerns rather than by a desire to beat their hurdle rates—are bidding up asset prices globally. In summary, geologic maturity, rising service costs, host government's hardball tactics and the emergence on the global scene of the NOCs may result in \$30 economics as the new minimum that high risk international ventures require in order to earn acceptable rates of return. In addition, many new F&D studies have been released and all show North American F&D costs up significantly to over \$10/boe depending on the study. Ultimately, this may be another reason we are unlikely to see \$20 anytime in the near future.

Operating Cash Flow

At this point we will review the 2004 vs. 2003 operating cash flows and analyze where the companies invested the funds. Our sample included the top 20 public oil and gas companies (the five largest IOC's and the 15



largest North American Independents).

Total operating cash flow of our sample increased 30% in 2004 over 2003 to \$157 billion from \$121 billion. This increase was largely commodity price-driven and not production volume-driven. In fact production volumes have been decreasing. The most significant reduction in volumes came from the IOCs which, for example, produced 1.2 bcf/day less North American gas in the 4th Quarter of 2004 compared to 4th Quarter 2003—a decrease of approximately 10%.*

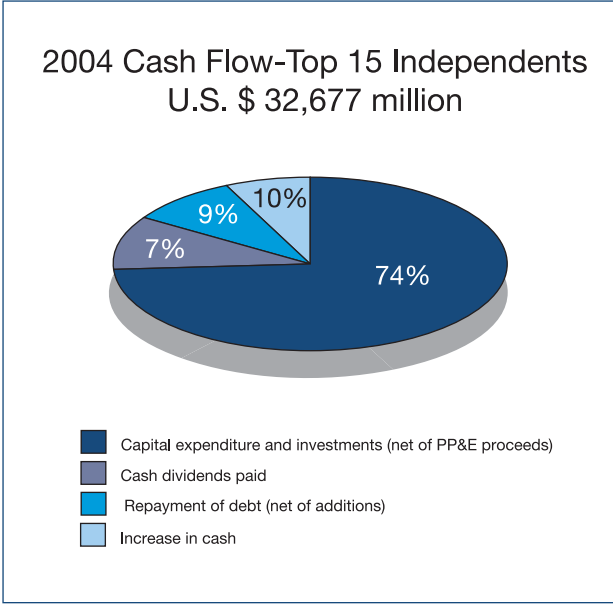
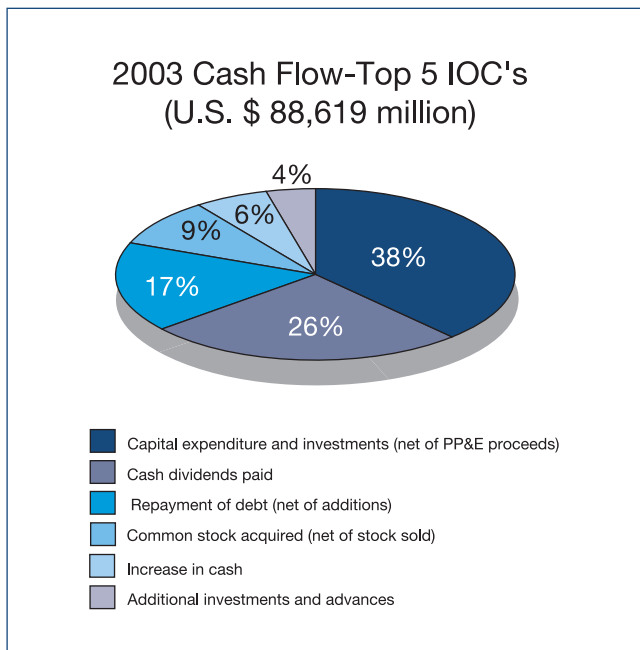
West Texas Intermediate (WTI) averaged \$41.50/bbl in 2004 compared to \$30.85/bbl in 2003. Natural Gas at Henry Hub (HH) averaged \$5.98/mcf in 2004 compared to \$5.34/mcf in 2003.

Although net capital expenditures increased to \$67 billion in 2004 compared to \$57 billion in 2003, as a percentage of operating cash flow this investment fell to 43% from 46%.

Cash dividends paid increased to \$28.7 billion from \$25.7 billion, but as a percentage of cash flow decreased from 21% to 18%. However, clearly companies have chosen stock-buy backs as the preferred method of returning cash to shareholders. The amount of stock buy-backs increased substantially from \$8.0 billion in 2003 to \$19.9 billion in 2004 up 148%, and represented 13% of

* According to John S. Herold Inc.

Fiscal 2003



2004 operating cash flow. Share buy-backs are traditionally utilized when management feels the market is undervaluing the stock. To date it appears Wall Street has responded fairly positively to the stock buy-back programs, as it does show prudence and that management has “shareholder value,” not just growth, at the very top of its priorities.

Debt repayment has decreased dramatically

from \$17.8 billion in 2003 to \$13.0 billion in 2004, as the market has become more comfortable with the company leverage levels, in the current interest rate environment.

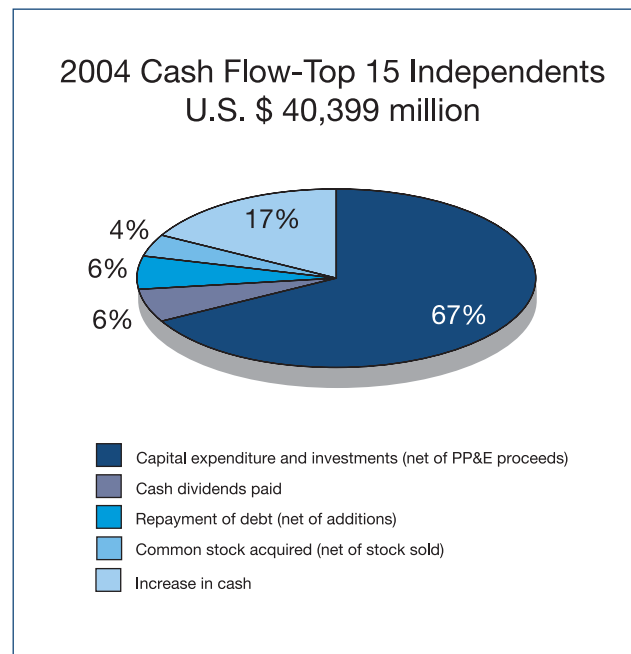
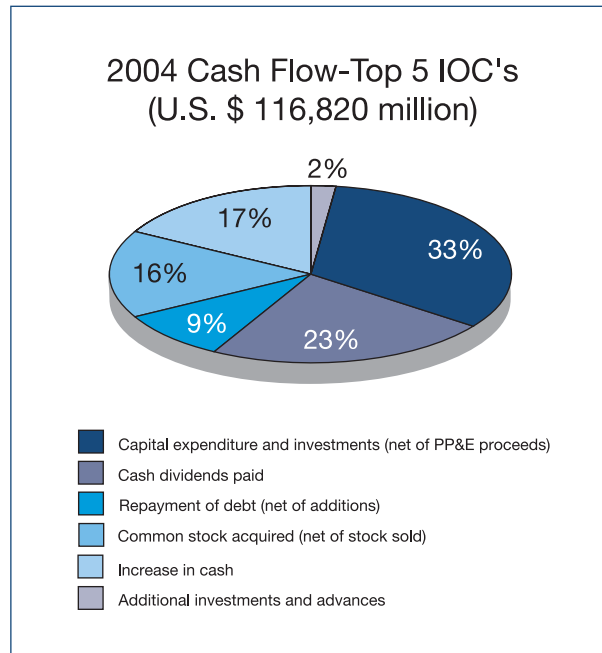
The final piece of the cash flow analysis above relates to the increasing cash levels on the balance sheet. A sizeable \$26.6 billion of the 2004 cash flow went unspent and accumulated on the balance sheet, as the cash accounts of our sample finished the year at over \$50 billion. Clearly this cash buildup highlights the opportunity constraints the industry faces—even though falling reserve replacement increases the pressure to find new projects, this growing cash pile shows how hard this is to do.

IOCs vs. Independents

The IOCs and independents have different cash spending strategies based on their shareholder base and hence market expectations. The IOC’s expectations are more total returns driven (which includes dividends) while the independents are more growth oriented with clearly a strong earnings focus (capital appreciation).

An analysis of the IOCs vs. the Independents is illustrated above.

Fiscal 2004



The biggest difference between the groups is cash dividend payments. The IOCs paid \$26.4 billion in dividends in 2004 representing 23% of cash flow, compared to the independents that only paid \$2.2 billion or 6% cash flow.

Independents reinvested 67% of their 2004 cash flow, which represented a 7% reduction from 2003; the IOCs reinvested only 33% of their 2004 operating cash flow, a reduction of 5% from 2003 levels.

The other noticeable difference between groups is the area of stock buy-backs. In 2003 the independents had minimal levels; and in 2004 they totaled \$1.7 billion or 4% of cash flow. The IOCs continued their aggressive stock buy-back programs totaling \$20.1 billion in 2004 up from \$8.8 billion in 2003, but consistently around 17% of cash flow.

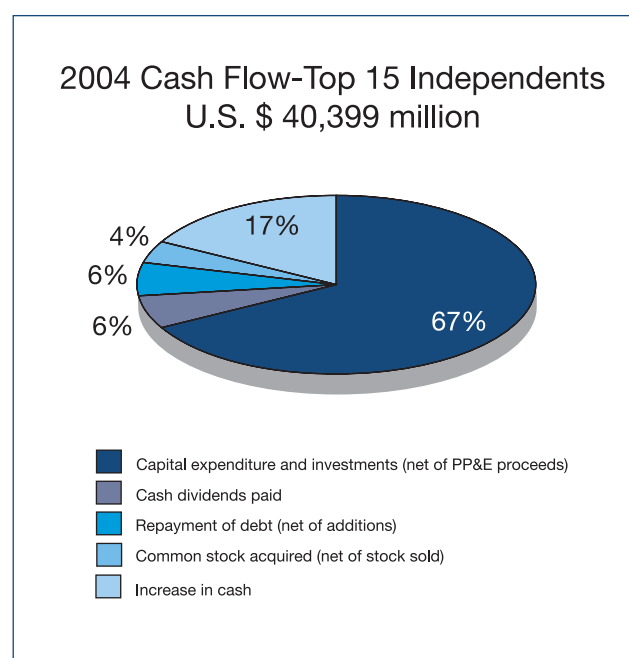
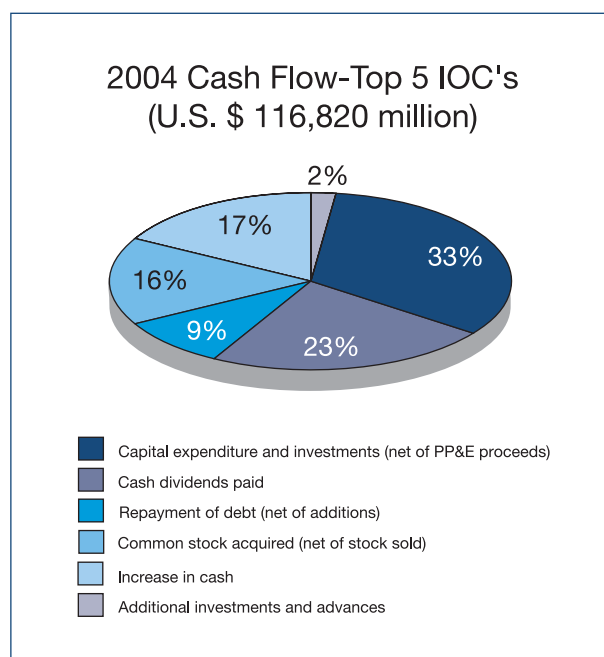
Finally, both groups saw their cash levels rise significantly, as 17% of 2004 cash flows were not invested and were retained on the balance sheet.

Rising Bank Accounts

Perhaps the most surprising part of the analysis is the rising levels of cash on the company balance sheets. Although it's difficult to estimate rates of return on these amounts, it's likely under 5%.

The first point to recognize is that the pace of these rising cash flows was likely unplanned or unexpected by company management. The decision to invest, repay debt, buy-back stock, or increase dividends can not be made simultaneously as cash flow levels increase. The continuing rising commodity prices make

Fiscal 2004



it difficult for management to react to invest immediately.

Secondly, many of the companies likely have plans over the next 2-3 years to increase investment; certainly we know this to be the case with LNG projects. In addition, the IOCs face significant downstream expenditures over the next 2-3 years as new sulphur restrictions become reality. Finally, it is likely that many companies are eyeing large international upstream investments, and we have already seen some of that activity.

Hedging Strategies

Another interesting area to review during this current cycle has been the companies' approach to their hedging strategies. Although the exact amount is difficult to obtain, we estimate that realized commodity price hedging losses in 2004 and 2003 were \$2-\$3 billion. What is particularly interesting is that the 2004 losses occurred at a time when companies were not spending, nor planning to spend all their cash flow, or engaged in significant debt repayment plans.

This would seem to suggest that oil companies utilize hedging programs as

an "offensive" not "defensive" strategy. If hedging is not utilized to protect a capital program or a debt repayment plan, then it likely reflects that company's belief that at historical high levels of commodity prices, some insurance needs to be purchased.

It should also be noted that the independents engage in significantly more hedging activity than the IOCs, who consider their integrated operations to be naturally hedged. Among the independents, the strategies vary significantly from very little hedging to 60%-70% of next year's production.

Finally, it is likely that significant hedging is done to lock in certain returns on acquisitions done at high prices. In some ways this is also a defensive strategy as it mitigates the possibility of a significant earnings disappointment should commodity prices turn downward.

M&A Outlook

Do these strong balance sheets and large cash levels mean an increase in M&A is likely? Not necessarily! Sellers continue to demand very high prices and the sector has shown

great discipline in the face of the highest extended commodity price cycle on record. However, the longer commodity prices remain high, I believe more executives, especially at the independents, will become comfortable with M&A prices at higher levels than the past.

As a group, our sample of independents ended the year with over \$12 billion on the balance sheet. While drilling will increase slightly (most 2005 Capex budgets are up 7%-8%), this small increase will likely be

predict, it is possible there will be a triggering event that may start a wave of M&A activity. It could be a major deal, (this tends to be a follow-the-leader industry) or a softening of oil prices which may increase sellers' desires to get something done. One could expect that any large deal would be combined with aggressive hedging to lock-in return levels in the early years.

As for the IOCs, one could expect them to focus on LNG projects, oilsands development, and large international joint venture opportunities. Where expected cash flow continues to exceed these investments, stock buy-backs will likely continue.

Conclusion

Early in the article I referred to \$160 billion/year in spending to meet worldwide energy demand. Although the National Oil Companies will increase spending as their cash flows increase, each of the countries (particularly OPEC nations) have their own unique issues that will result in these increasing cash flows being channeled elsewhere and not reinvested in the oil fields. Therefore, it is this group of companies led by the IOCs that must continue to lead the way and deliver the needed investment.

The cautious investment approach of the last two years has been a positive development. The result has been a much needed increase in credibility from the investment community for an industry that has been criticized in the past for uneconomic investments during short-term high commodity price cycles. It is likely that over the next eighteen months however, that cash investment allocation percentages will return to their higher 2003 levels. In addition, the \$50 billion on the balance sheet will begin to be reinvested in exploration and development or utilized in increased M&A activity. Fiscal 2005 could ultimately be the beginning of a period of the highest increase in capital investment ever by the major players in the oil and gas industry.

fully financed from operating cash flow which is forecast to be at or above 2004 levels. Additional spending activity would likely entail a significant increase in exploration activity and so far the companies have shown that they simply feel the risk/reward is not present, even at these commodity prices. In addition, substituting new international production is not without its challenges. Large new fields are usually in deep water areas, and can take 5-7 years to develop. The bottom line, finding and developing oil and gas is becoming difficult and expensive. Therefore given the need to grow and to show growth sooner rather than later, acquisitions remain the best alternative, and this activity will be financed with the war chest noted above. Although difficult to



© 2005 PricewaterhouseCoopers LLP. All rights reserved. PricewaterhouseCoopers LLP refers to the PricewaterhouseCoopers LLP (a Delaware limited liability partnership) or, as the context requires, other member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

HS-HS-06-0052

www.pwc.com

PRICEWATERHOUSECOOPERS 