Global Banking & Markets

# The 5th RBS North Sea Conference

## Market Survey

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The Royal Bank of Scotland

# Introduction

The theme of the fifth RBS North Sea Conference in Aberdeen is the maturing nature of the UK Continental Shelf and the impact of both economic and government forces on realising the basin's full potential.

Having grown in both size and scope since its inception in 2001, the conference, run in conjunction with the Department of Trade and Industry, has become a key industry forum promoting interest and investment in the North Sea.

Seven hundred invitations were emailed by The Royal Bank of Scotland to senior figures in the industry in early September 2005. These included representatives from Major and Independent oil companies as well as providers of support functions, regulation and research or development to the sector.

The registration form included questions on the current and future geographical focus of their companies. Analysis of 416 completed registration forms provides an indication of likely change in geographical focus over the next five years.

In addition, those registering were asked to complete a 24 question online survey designed to capture their views on the key challenges facing the industry. A total of 90 responses were received before the analysis deadline of 30th November 2005.
The online survey was supplemented by 10 in-depth interviews with key figures from well-known companies in the sector, conducted in November 2005 by Charterhouse Research, a specialist financial and business market research consultancy.

Objectives of the research were to understand the key issues facing the oil and gas industry currently and over the next five years and to explore:

- Access to rigs and equipment on business and investment decisions and the impact of decommissioning liabilities for offshore infrastructure.
- Attitudes to the current finance and tax regime, and to possible tax changes, and sensitivity of investment plans to changes in the UK fiscal regime.
- The impact of high commodity prices on business and investment decisions, and long term oil and gas prices used to assess project viability.
- Perceptions of government understanding of the oil & gas industry and how to ensure long term investment into the North Sea.
- The extent to which debt and equity capital is accessible by companies involved across the energy value chain and whether providers of these forms of finance understand the issues facing the industry.
- Perceived likelihood of further significant discoveries in the UKCS and estimates of the amount of remaining North Sea oil likely to be recovered.

- What geographical focus companies have now and expect to have in five years time.

This report contains the findings from the online survey and depth interviews, all of which were completed before the Chancellor's December 2005 pre-Budget Report announcing increased oil taxes.

# Executive Summary

- Almost all agreed that further exploration was essential for the future of the North Sea Basin, with half expecting this to be undertaken by large independents such as Nexen, Apache and Talisman - most of the remainder thought it most likely to be medium independents like Paladin, Tullow and Venture. None thought the majors would undertake this exploration, though the diversity of opportunity was seen by some as offering niches for a wider range of players than ever before.

- Nearly all (94%) thought access to rigs or equipment will impact the ability of upstream companies to increase production over the next two to three years – and over half said that cost increases and/or delays had already hit their projects. An adversarial relationship between operators and the service sector was thought to hinder the technical development necessary to maximise extraction in future.

- Nine out of ten thought industry cost estimates of decommissioning liabilities were incorrect and that this impacted on business and investment decisions - but were divided on whether costs were over or under-estimated. These liabilities and the tax implications were seen as preventing maximum production by hindering asset and infrastructure transfer and a barrier to entry for small companies.

- While two-thirds said commodity prices used in investment decisions had moved in line with product prices, only 2% had moved exactly in line. Median prices used were $33/bbl for oil and 23p/Therm for gas. Oil price stability was seen as important for investor confidence - while some said higher prices encouraged investment, others said deal flow had slowed and assets were harder to acquire.

- Nearly 20 billion of the estimated 28 billion barrels of remaining North Sea oil was the median amount expected to be recovered – some thought higher oil prices would lead to new discoveries and recovery of more than 28 billion barrels.

- Half thought the pre-December 2005 finance and tax regime was adequate to stimulate sustainable, profitable North Sea operations but more than a quarter disagreed. Over 60% said their investment plans were sensitive to tax changes.

- More (43%) thought “regular” was the right word for UK government involvement in the industry – 27% thought the word was “occasional”. Half thought Government involvement was at the right level to maximise recovery but 42% disagreed.

- While half thought the financial debt markets understood the industry and had the range of debt structures required, only a third thought debt markets sufficiently flexible in providing support. Fewer thought the financial equity markets understood the industry or had the range of providers or flexibility needed.

- Though half thought further significant North Sea discoveries like Buzzard likely, fewer than one in ten thought this very likely – many had a gut feel there would be one or two more significant discoveries as technology improved. Smaller fields were thought likely, with viability subject to connection to existing infrastructure.

- The Middle East, Russia/FSU, Africa, South America and Asia are expected to be the main beneficiaries of a shift in geographical focus away from the North Sea over the next five years – almost half thought West Africa would benefit. While 70% thought there would always be a role for the majors, most thought an eventual exit of North Sea-focused companies inevitable from 2010.

# Exploration and Recovery

Further exploration of the North Sea Basin will be driven by the Independent sector rather than the Majors. Nearly half of those surveyed thought exploration would be undertaken by the larger independents such as Nexen, Apache and Talisman; most of the remainder thought it would be done by medium sized firms like Paladin, Tullow and Venture.

There is a strong sense that the Majors are moving on from the North Sea Basin and are putting their resources, capital and people, into other regions. One Oil Company executive said *“The majors have shifted to other parts of the world where there are opportunities to make bigger finds. The size and scale of things over here now, it’s the independents that will further develop them.”*

This shift has created an opportunity for the Independent sector who still see a considerable opportunity in the area and are prepared to invest. For many the difference between the Majors and the Independents approach was seen in the teams that were allocated to the assets. Typical among the comments was this, from an Oil Company executive *“In a lot of smaller assets run by the majors, they don’t get an A or B team, they probably get a C team, whereas they’re getting the independent’s A team. It’s not that the majors don’t have the people, it’s just that their best people are off working in Angolan Exploration or Siberia – on the big flagship projects”*

## Likelihood of further UKCS discoveries

The jury seems to be out in terms of any major new discoveries in the North Sea. Respondents were almost equally divided on the likelihood of further significant discoveries like Buzzard – 53% thought it likely (though only 7% of these said very likely) while 48% thought it unlikely – and the views expressed by oil companies were equally balanced, even contradictory.

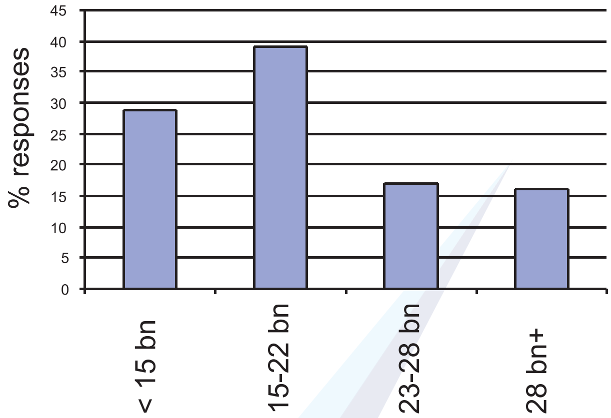
In your opinion, what is the likelihood of further ‘significant discoveries’ (e.g. Buzzard) in the North Sea Basin?

| | |
|---|---|
| Very likely | 7% |
| Likely | 46% |
| likely | 46% |
| Very unlikely | 2% |

*Source: on-line survey*

For example, *“It’s been well explored by big oil companies that have poured resources into it and I don’t mean there isn’t a lot still out there but I don’t think we’re going to get the big finds again”* contrasts with a view that *“To think there are not other major fields out there is very unlikely. As technology improves, the current enthusiasm will certainly spawn more drilling activity. I’d be astonished if there were not other major finds, given the size of the area.”*

***Of the estimated 28 billion barrels of oil equivalent remaining to be recovered in the North Sea Basin as estimated by UKOOA in its Economic Reports 2005, how much do you think will actually be recovered?***




More likely perhaps is a future based on smaller fields than a new Buzzard, which may turn out to be the exception that proves the rule for the North Sea Basin.

Asked to what extent they envisaged smaller fields in the North Sea in the foreseeable future, most of those interviewed agreed that this was likely, but subject to connection to existing infrastructure via area hubs:

*"Small fields and an ability to develop those economically will be hugely significant; the ability to develop sub-sea technology to bring and tie back small fields into existing infrastructure will be very important and our ability to maintain the existing infrastructure to tie back new discoveries will be key. Equally important will be accessing newer oil and gas from old fields which could provide at least as much new oil and gas as the new fields"* (Oil company)

*"If they are close to existing infrastructure and owned by somebody already, then you might find what I would call brown field development and then the majors are interested. But they are not going to be interested in small fields in unexplored areas."* (Industry commentator)

The technology and infrastructure case is interesting but there were words of caution expressed about whether there were the firms with sufficient scale to attract the funding and accommodate the risk but still small enough to remain independent.

*"We're missing the guys in the middle who are entrepreneurial but have the capital to get things done. For a North Sea oil field you need £100 million – there's a gap between the guys who raise £10 - £20 million and those who've got billions, you need someone in the middle."* (Oil company)

## What proportion of the remaining oil will be recovered?

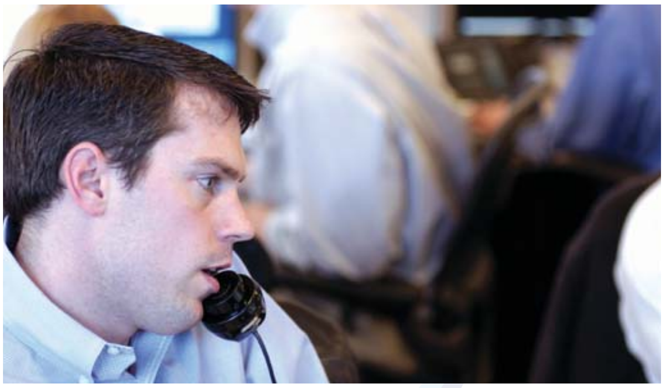
Of the 28 billion barrels of remaining oil estimated by UKOOA the prevailing view of those surveyed was that less, and for some significantly less, would be actually be recovered. Only one in six thought that more would be recovered. One industry commentator interviewed for the survey said "There is a lot more than that, the DTI's top end figure is 42 billion, so 28 can reasonably be recovered. Some of it is not discovered yet, and we're having to make projections on how much more is going to be discovered" However, the more typical conservative reaction was:

*"I would hope 15-20bn if we do a good job. Things are remote, too risky, the risk in them is greater than people expect. While they might be a good project, they're just not good enough."* (Oil company)

*"They always start out big and end up much smaller and costing much more to complete and taking longer to complete … I suspect it would be much smaller."* (Oil company)

Several thought the proportion couldn't be estimated because it would depend on the oil price or the impact of changes in the tax regime:

*"I think there's a lot of oil that could be recovered. If the price goes to $100 a barrel, we'll be back into abandoned fields, sucking out more and technology will be available to assist that. If the oil price remains at $30-40 that oil will never be recovered."* (Oil company)



# Availability of Resources

At every turn the industry sees barriers and constraints. These take the form of practical considerations such as access to rigs and equipment as well as the recruitment of personnel to manage and deliver the activities. Other issues include co-operation and co-ordination within the industry, companies using economic models with oil still priced at $20, and a cost-plus approach to buying services which discouraged technical innovation. The survey also highlighted planning issues such as decommissioning liabilities.

## Access to rigs and equipment, people

Access to rigs or equipment will impact on the ability of upstream companies to increase production over the next two to three years. A little over half of those surveyed (57%) said that some of their companies' projects had been affected by increased costs or delayed start dates as a result. One executive said *"You have to book earlier or hope you get an option that somebody else isn't using, which is not a good way to run your business – you're paying market rates and the oil service companies have us over a barrel. But the reward in the event of success given the current oil price environment is very high."*

The access issue raised the subject of planning and the industry seems to suffer from either poor planning or a severely unpredictable environment. As one adviser commented *"It was not many years ago that rigs were sitting idle and they were laying everybody off. It's not surprising there are shortages today and they delay developments"*

Combined with an oil industry herd instinct that led to skilled staff being laid off and lost during lean times:

*"It's imperative that the industry acts on the fact that the North Sea is going to be around for at least another generation yet and we need collectively, along with Government, to ensure that there is the next generation of skills and resources to realise the remaining potential."* (Oil company)

| Have any of your company's projects been affected by access to rigs and/or offshore contractors, services and equipment? | |
|---|---|
| Yes – increased cost | 14% |
| Yes – delayed start date | 14% |
| Yes - increased cost and start date | 29% |
| No | 36% |

*Source: on-line survey*

and not being replaced because of the greater attraction of other industries to newly-qualified engineers:

## *Thinking about decommission liabilities for offshore infrastructure, do you think that costs, as estimated by the industry are…?*

| | |
|---|---|
| Significantly under estimated | 26% |
| Marginally under estimated | 27% |
| Correct | 13% |
| Marginally over estimated | 23% |
| Significantly over estimated | 11% |

*Source: on-line survey*

*"Why would an engineer out of college want to come into the oil business when he knows within 3 years the industry is going to go through a downturn and everyone's going to get fired, when he can go somewhere more glamourous like software, telecoms or biotech?"* (Oil company)

## Are decommissioning costs under-estimated or over-estimated?

One of the biggest constraints on the development of the North Sea would seem to be the industry estimates of decommissioning costs. Over half thought the costs were under estimated, either significantly (26%) or marginally (27%) while a third thought these costs were over estimated. Only one in eight thought estimated costs were correct.

Nine out of ten thought this had some impact on business and investment decisions, of whom a quarter thought it had a lot of impact (24%)

The impact of uncertainty about decommissioning cost estimates on investment decisions was seen by some as substantial. One interviewee said the impact was *"..huge. When you're valuing an asset with a negative value and you're uncertain what the legislation will be, what your final costs will be, it's very difficult to determine."* (Oil company)

and another seeing decommissioning liabilities as overstated said that *"Because so few assets have been decommissioned, the outrageous levels of abandonment liability carried by the majors can't be disproved … we've had independent estimates by people who'd done it in the Gulf and their view is that estimates carried by the majors are hugely overstated."* (Oil company)

while several felt that decommissioning liabilities were a barrier to entry for small companies, a drag on decision-making, and prevented maximum production:

*"The large companies have massive balance sheets and are exactly the right people to manage it, but for smaller companies that is life and death. As with any large risks they should sit with the person best able to understand and manage it."* (Oil company)

The need to provide for decommissioning through bank guarantees, security or letters of credit were seen as tying up investment funds, reducing borrowing power and deterring new entrants who could have increased oil and gas production.

*"There are opportunities to produce oil and gas next week, which are not made because they sit underneath a large field, in which the owner is not investing. If it could be solved across the North Sea it would trigger an avalanche of new deals and investments."* (Industry adviser)

*"Contracting regimes have not changed for over 10 years with the adversarial and win-lose relationships still prevalent"*

There were also concerns about the effect of possible PRT abolition:

*"It could encourage bad behaviour. Our sole objective is to keep it all going as long as it's economic. If the tax system sends the wrong signals, you could get people doing the wrong things for UK PLC but the right thing for their shareholders and company. You need to have those two things pushing in the same direction."* (Industry commentator)

Some felt that because higher oil and gas prices were extending the life of assets, the resultant lack of attention to decommissioning issues meant that solutions to the problem were not being actively sought.

## Operators view of the service sector

Feedback ahead of the last conference in 2004 hinted at significant differences in perspectives within the industry between operators and the service sector. For this conference we explored this a little further among all respondents.

When asked to describe the prevailing operators' view of the service sector and whether this had changed during the last three years, many referred to an adversarial relationship. For example:

*"Too narrow, unwilling to share risk and reward. Contracting regimes have not changed for over 10 years with the adversarial and win-lose relationships are still prevalent. Very few significant changes over the last 3 years."* (Consultant)

*"Still a strong master/servant relationship - unchanged in the last 3 years."* (Asset management)

*"Edwardian aristocratic - 'Why are you not able to do it tomorrow? What do you mean we were unkind to you in years gone by? We have always been good to our servants."* (Finance)

*"Highly competitive market that can be pressed to reduce margins continuously. Seen as incidental to value creation. Some signs of recognition of value creation have started to appear, but reward does not reflect this. Still see themselves as custodians of expertise, not the service sector."* (Asset management)

Some commented on the rewards the service sector was seen as reaping from current demand, with differing reactions to this:

*"Service sector is only reaping the rewards of several years of suppression from operators."* (Management)

*"Somewhat disillusioned tainted by the rates being charged by drilling companies and subsea. I think they consider the quality very good but have questions about the delivery. The sentiment has hardened over the past 3 years because of rig rates."* (Technical/subsurface)

*"Increasing consolidation amongst mid sized to independents, and increasing churn in portfolio as well as the supply chain to maximise exploitation"*

Several felt that this view of the service sector inhibited technical development: *"The operators still treat the service sector with a degree of contempt, rig contractors profit from the current high oil price and the service sector is being squeezed, it is irrational, without a decent return to our investors the service sector will not be able to develop the new tools/technologies that will be necessary to extract hydrocarbons from more complex deposits."* (Commercial)

*"Large majors restrict and avoid innovation from the supply chain, making it difficult for the rest to find the innovative approach they need."* (Asset management)

A few thought things were changing because of a growing realisation that the operators needed the service sector to help develop technical solutions for the future:

*"There may be a little more recognition that operators and the service sector need each other. But the laws of supply and demand still apply."* (Exploration)

*"As 3rd party contractors to be exploited. Changing slowly to view as business partners."* (Consultant)

*"Used to be about driving down prices - now there is a realisation that this also drove down investment."* (Facilities)

## Transfer of oil & gas assets and infrastructure

With a future seemingly dependent on an independent sector getting access to fields, equipment and personnel within an effective business and industry model the survey asked how much activity was expected in the next 18-36 months with regard to the transfer of oil & gas assets and infrastructure.

The majority view was that transfers would be from Majors to Independents although there were a range of views about the levels of activity that might be seen in this area with one critical dependency being the price of oil. The Government begins to emerge in this topic as both a beneficiary through improved industry efficiency and therefore tax revenues but also as a significant influence through the tax regime.

Comments from those expecting significant activity included:

*"Significant with small and medium E&P companies and utilities benefiting, unless changes in taxation disrupt activity."* (Management)

*"Increasing consolidation amongst mid sized to independents, and increasing churn in portfolio as well as the supply chain to maximise exploitation. Main beneficiaries will be mid sized players."* (Consultant)

*"$5-10 bn of asset transfers as a minimum. All parties in the transactions will perceive benefit otherwise they would not participate in the sale and purchase. Other beneficiaries will be lending institutions, advisors and the treasury who will benefit from increased revenues that new ownership generally brings."* (Consultant)

*"30% increase over the last 2 years. The main beneficiaries will be the Government, through enhanced tax revenue and long term security for decommissioning, the majors through removing uncertain liabilities from the balance sheet, securing the environment and releasing them to concentrate on more profitable areas of the world and new investors through realisation of new, significant returns which would otherwise remain undiscovered."* (Finance)

*"As long as the oil price stays as high as it is there will be modest movement. Once it starts to slide there will be a dramatic increase."* (Technical/subsea)

*"Without a fall in the oil price it will continue to be somewhat stagnant. A price fall could cause a rush to the exit. The main beneficiaries will be the UK/US independents, the Japanese and a few start-up companies."* (Banking)

# Pricing

The need for stability is mentioned throughout the survey and whilst interviewees were divided in their response to actual prices the majority were agreed in a need for overall stability of oil pricing. For example, one oil executive said *"part of the reason why we are facing [the current] predicament in the world, is because we have gone through years of fluctuating prices and lack of investment and we need some great stability."* Price stability is considered an important basis for investor confidence, with some considering stability more important for confidence than actual price level.

## Prices used for investment decisions

Seven out of ten online respondents (71%) said that the commodity prices their companies used for project investment decisions had moved in line with product prices – but only 2% of these said that prices had moved exactly in line.

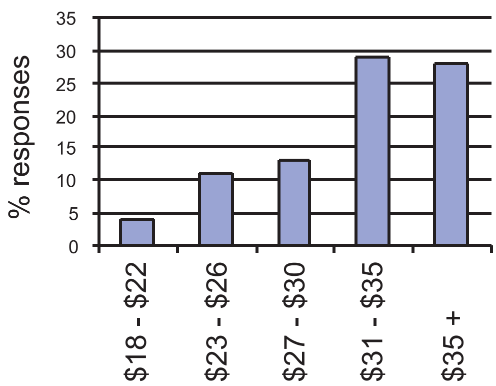
When asked about assessing the economic viability of a North Sea project, a range of prices is used for both oil and gas.

An oil price of between eighteen dollars to over thirty five dollars per barrel is used. A majority (57%) used an oil price no greater than $35/bbl when assessing the economic viability of a North Sea project – but 28% used a price over $35. The median oil price used was $33.

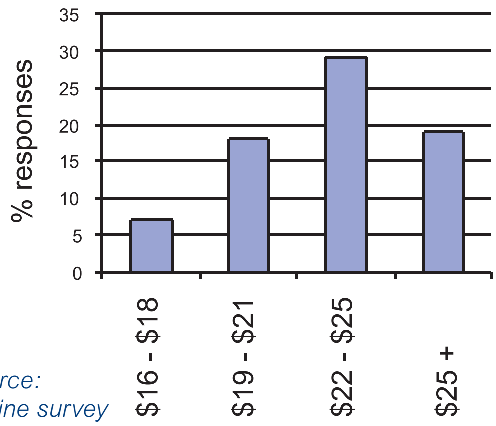
For gas, a range of prices between 16p and over 25p is used. Just over half (54%) used a gas price of 25p/Therm or less while 19% used a price over 25p - the median gas price used was 23p.

What long term oil / gas prices does your company use when assessing the economic viability of a project in the North Sea?

Oil ($/bbl)




Gas (p/therm)




*Source: on-line survey*

*"Nobody is going to behave as if it's $60 forever because that is the quickest way to the dole queue"*

## Impact of high commodity prices

Respondents were split on their attitudes to the impact of high commodity prices.

Some of those interviewed felt that higher commodity prices encouraged investment by increasing capital availability and making it economic to re-work existing fields:

*"Higher prices are supporting investment decisions and giving us the ability to re-work existing fields because you can justify the cost."* (Oil company)

*"It's spawned a lot of smaller companies that are positive and welcome entrants. Previously oil and gas exploration was seen as a pure risk activity compared to something like technology. All the risk capital was going into technology and not oil and gas. Now people have a more balanced assessment and there's quite a bit of risk capital coming in."* (Oil company)

However, others thought higher prices had reduced the number of deals, with Independents finding it harder to compete for assets with larger foreign companies with access to tax breaks:

*"It has slowed up the deal flow, and made it difficult to compete in the standard asset acquisition because there is a proliferation of companies looking to acquire producing and development interests with much bigger cash resources. It can end up typically being a cheque writing contest."* (Oil company)

Despite expectations of higher long-term oil prices, oil companies were seen as reluctant to increase the price they used to make investment decisions because of the risk of falling prices during the three to four delay before production.

*"Nobody is going to behave as if it's $60 forever because that is the quickest way to the dole queue. People will slowly increase the level at which they assess projects from $16 three years ago to $25 now."* (Industry commentator)

## Is the current oil price too high?

Again interviewees were divided in their response – three of the seven oil companies thought the current oil price was too high:

*"The answer is yes but the question is where should it be … I think the $30's have definitely gone, the $40's are unlikely, $50's are at the top end of the market. Conceptually it is hurting us and people see it as a bad thing. In the $50 range, people are going to have to accept it because that's where it's going to be."* (Oil company)

*"I think something above $50 but not at the current levels is probably more realistic … but it is driven as much by fear and emotion than by logic and information, so I'm sure I'll continue to be wrong!"* (Oil company)

*"At $60 and petrol at a pound a litre, various emotional thresholds are reached and people start behaving in strange and unpredictable ways"*

Others said that the current price reflected the fundamentals of the market price:

*"The fundamentals to support a high price are now aligned in a way they've never been before - our friends in Saudi can't just turn on the taps, there's very little additional capacity and developing country demand is continuing to grow – I'd put bets on it at 45."* (Finance)

*"I believe in the market, if the market say's that what the price is, then that's what it is. If there are too many forces putting it down then it will go down. It's much higher than we have had before, but who is to say in 5 years time it might seem quite cheap."* (Industry adviser)

Some felt that higher oil prices were beneficial in encouraging conservation and attracting investment to alternative energy forms:

*"At $60 and petrol at a pound a litre, various emotional thresholds are reached and people start behaving in strange and unpredictable ways,* *start talking about building nuclear power stations or covering the country in windmills so I think probably in the real value of the commodity to society they're probably not far off. Higher oil prices clearly encourage two good things; substitutions for other sources of energy and conservation because we have a finite resource to husband for those things we need it for, not those that happens to be convenient today."* (Oil company)

*"A sustained globally high price will have a long term effect of attracting investment to alternative forms of energy so will probably increase diversity in global energy supply. In terms of North Sea competitiveness given it's a high cost area, high oil price helps but the key is the view on whether that high oil price is sustainable throughout full life of projects and given that average project life span is 15-20 years it's a short term nice-to-have but we'd need to see some certainty that oil price was going to stay high for the long term which we haven't seen in history."*
(Oil company)

## Benefits of oil price stability

Among those interviewed, oil price stability was considered an important basis for investor confidence – but the days of OPEC controlling the price within a range were thought to be over.

*"Stability in pricing is important; it does not matter at what level. You want to know the likely price outturn is within plus or minus 5-10% not plus or minus 100%."*
(Oil company)

While the past year's instability and range of $40 to $70/bbl had caused concern, a growing consensus that a return to sub-$40 prices were unlikely had provided some confidence.  A few were concerned that increased global exploration, driven by current prices, might lead to lower prices in 5 years' time and that low cost production areas elsewhere might then make North Sea oil production uneconomic.

*"The industry has to be flexible to variations in commodity price, but a period of sustained high price over 5+ years will bring added confidence so investments will go ahead that otherwise might not have done. The downside is that cost inflation is such that the North Sea couldn't compete if the oil price fell back to levels it was 2 or 3 years ago."* (Oil company)

The impact of price instability on future planning and investment was highlighted by several oil execs. One said; *"whether it's industry as input costs, whether its companies in terms of planning assumptions, whether its investors or banks in terms of the attitude they take to things, I think high or low, both are fine within bounds, but stability is better than any of them."*

The possibility of inertia in the market was also raised. Fluctuating prices were thought by one oil executive to result in a reluctance to engage with the sector. *"People believe that the prices are still unrealistic; people are unwilling to buy things at these prices because they buy assets all over ground at these prices because they think the price may go down, so there are scared to buy. People do not want to sell at those prices but they enjoy such large cash flows – why would you want to sell.  So in the transaction market between people buying and selling assets with the high prices have created an ebbing of deals. If prices are much stable everyone is comfortable and buying and selling."*

# Finance and Tax Regime

The interplay between internal and external factors in the industry is complex and the role of Government, as the most significant external force, is a topic that is never far from the centre of any feedback. Just over half (51%) agreed to some extent that the Finance and Tax regime currently in place (before the Chancellor's statement increasing tax) was adequate to stimulate sustainable, profitable operations in the North Sea.

Despite the usual diverse range of views there was unanimity on the need for stability, captured in the most striking comment made on any topic this year "The Indonesian tax regime is more stable than the UK regime - Indonesia has only had about 2 to 3 changes where the UK is always tinkering with this and that. It's the predictability and stability of the tax regime which is key" (Industry adviser)

Rather worryingly, given the desired future direction of the industry, some independents said that the current tax regime provided insufficient incentive for exploration and development, compared with some other oil-producing areas:

*"It's a bit of a blunt instrument. It should penalise companies who are harvesting and incentivise companies who are investing to recover some of the 22billion barrels. The benefits would far outweigh the theoretical cost to the Exchequer."* (Oil company)

## Sensitivity of investment plans to changes in the UK fiscal regime

Nearly two thirds of those who responded to the survey said that their investment plans were sensitive to changes in the UK fiscal regime and when asked what they would like to see as the outcome of any review of the North Sea tax regime, several respondents felt there should not yet be a review of the tax regime, given the impact of the 2002 changes.

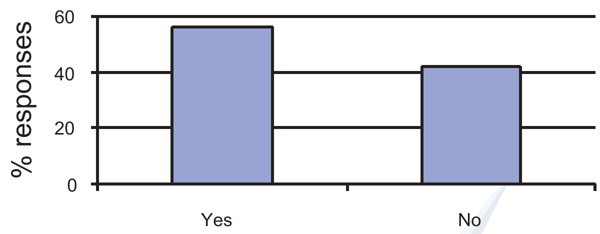
| How sensitive are your investment plans to changes in the UK fiscal regime? | |
|---|---|
| Very sensitive | 14% |
| Fairly sensitive | 47% |
| Not that sensitive | 28% |
| Not at all sensitive | 8% |

*Source: on-line survey*

*"The last increase in 2002 had a detrimental affect because it caused people to hold back on UK investment, but people are now putting that behind them with a higher pricing environment - potentially another increase in the taxation would have a similar effect."*
(Oil company)

*"We should just stay where we are. Stability is crucial in terms of giving investors confidence. If you start messing around with it there are going to be winners and losers, creating problems."* (Oil company)

## *In your opinion, is this the right level of involvement for the industry to maximise the recovery of the resources?*




*"The Government is making a huge windfall from oil companies; we're paying much more tax this year than anticipated. If there were a change we would have egg on our faces on some transactions we're looking at."* (Oil company)

However, some felt the higher oil price justified a larger tax and some hoped that the tax regime may be used, positively, to redirect efforts to future development needs.

*"The Government needs to increase its tax take because I am a shareholder of UK PLC but it needs to redirect the focus towards exploration and development to sustain the UK in the long term."* (Oil company)

*"Other regions have brought in strong incentivisation for exploration drilling, particularly for early stage businesses. Anything that encourages exploration and development is a good thing."* (Finance)

*"I'd like to see some differential treatment between oil and gas. The UK is becoming a gas importer and has under-invested in gas infrastructure and has a pretty perilous gas supply/ demand position - people should be incentivised to try to discover indigenous gas."* (Oil company)

## Attitudes to Government involvement

The separation between the Treasury and the Dti in the industry is well understood. Just over half thought the present level of involvement by the Government, and this effectively means the Dti, was right to maximise the recovery of resources. An encouraging level but more than 4 out of 10 (42%) think that the Government has yet got it right.

Those in favour of the present efforts praised the open regulation (and warned against creeping European legislation), their promotional efforts and some innovative schemes like Fallow and Promote.

*"DTI are doing a good job freeing up acreage and opening up infrastructure, Treasury are a threat we could do without."* (Consultant)

*"Need consistency of approach and regular involvement facilitates this."* (Finance)

Those more critical cite the need for even longer term planning, a perceived policy bias towards Majors and a lack of co-ordination between the Dti and Treasury and perhaps, in the following comment, a limited exchange of ideas and people between Government and the industry.

*"It's under pressure from this Government and all the political parties to be scaled back or even closed down"*

*"Most companies are better qualified to estimate investment opportunities than bureaucrats that have come out of majors indoctrinated to be pessimistic."* (Management)

The extent to which the government had a sufficient understanding of the oil and gas industry was explored in some depth. Though some felt the government understood the industry well, many felt that the DTI's understanding had declined and its influence had lessened.

*"Not well enough, DTI understanding has declined as they've lost a lot of experienced people. It's under pressure from this Government and all the political parties to be scaled back or even closed down. Its role in promoting the industry seems to have stopped."* (Oil company)

*"The DTI is staffed with people whose commercial nous is extremely limited. They understand the industry but don't understand how to get things done in the industry. They're insufficiently robust."* (Oil company)

*And there was particular concern about lack of dialogue between the DTI and the Treasury "There is this enormous secrecy that surrounds the Treasury, and I think that there is little dialogue between the DTI and the Treasury. Where it falls down is when you see how the Treasury evolves its policies. They are definitely not in touch with the industry."* (Industry adviser)

## Government action sought to help ensure long-term North Sea investment

What more can be done? Ideas concentrated on incentivising exploration and development of smaller fields and the transfer of assets from Majors to Independents, or at least incentivising majors not to close down existing field infrastructure.

*"Encourage the transfer of assets from majors to people that are going to do things with them. If the majors cause the premature abandonment of some of the infrastructure that brings oil & gas to the UK then all the oil that lies around it is going to be los.t"* (Industry adviser)

In addition, co-ordination with the Treasury to provide stability of taxation was seen as important to reduce uncertainty and encouraging investment in oil exploration and recovery. Avoidance of multi-layer regulation seen as a key factor in encouraging investment and continued exploitation of North Sea oil & gas, reflecting serious concern about impact of European marine and environmental regulation on the industry:

*"You have two different strands in environment policy coming out of Europe. We have our own marine bill, there are three layers competing from Europe, with governments fighting about whose bill is going to be the most important. The government talks about not wanting multi*

*Thinking generally about the support provided to the oil and gas sector do you think the financial debt markets….*

| | |
|---|---|
| Understand the industry sufficiently | 53% |
| Have the rage of debt structures to support industry requirements | 46% |
| Are sufficiently flexible in providing support | 28% |

*Source: on-line survey*

*layer regulation, but thats is precisely what we have coming and they need to think about that."* (Industry commentator)

*"A regulator would make a huge difference. With industry and commercial experience, not a civil servant, backed up with commercially minded people could seriously move forward a lot of the issues."*
(Oil company)

## FINANCE

### Access to debt and equity finance

While some would welcome more competition from other banks for North Sea debt finance, most did not see availability of debt as a problem...

*"Debt capital will always be difficult for smaller companies and there's no reason why it should be a whole lot easier than it is now. Where do you want the risk to go? If you're raising equity easily then the risk should be on the equity holder, not the banks, and it's really an equity project not a debt project."* (Oil company)

*"At the moment there's too much access to capital. The banks have seen that there are not enough opportunities to put the money into …and there are plenty of finance institutions with empty books and lots of cash."*
(Oil company)
…though some thought that companies developing a single field had difficulty accessing debt because of their limited spread of assets:

*"Debt's not really available for one off development so it's a major problem because smaller companies don't have a portfolio of assets to back up the development opportunity. The only way smaller developers will get off the ground is through equity and that's difficult."*
(Oil company)

Though banks were seen by some as using outdated reserve-based lending models in assessing proposals, focusing too little on management's track record, others acknowledged the development of new financing products:

*"In the last 3 or 4 years, the banks and private equity providers have become much more flexible and innovative in structuring products for marginal fields, geared to high oil prices. The evolution of bespoke senior debt products or quasi-mezzanine products or products which have the characteristics of both debt and equity is something which is important and has been done quite positively. I have to say the Royal have been more to the forefront than others in doing that."*
(Oil company)

*"We are entering a stage where the financing of the North Sea has a more significant part to play than in the past"*

Most felt there was plenty of equity capital around for the right proposition but that single field exploration and development would always be high risk and difficult to finance.

*"Right now any man and his dog can raise money, it's not a problem – it's expensive, it always is. To get money these days, you don't even have to have a licence; you can raise money on a promise."* (Oil company)

While acknowledging availability of private equity, some thought there room for more private equity providers with more knowledge of the oil and gas industry.

*"Equity providers and banks are taking a standard business model for senior debt and finding ways to stretch it to increase the risk which they take in order to get the business. The banks have been stretching the model quite successfully, and there have been new equity providers coming in but there are not really enough specialist equity houses."* (Oil company)

*"You've now got a new breed of people with different capital structures to the majors who need their own equity providers, financial providers and debt providers, and there are not enough people out there doing it creatively."* (Oil company)

## Do finance providers understand the issues facing the industry?

Most leading providers of debt and equity capital were seen as having in-depth understanding of the industry but needed to evolve to meet the needs of smaller, faster-moving operators.

*"Historically the industry was dominated just by a few big players, so the local finance houses didn't have a huge significance because the big players were able to take on the risks themselves. We are entering a stage where the financing of the North Sea has a more significant part to play than in the past."* (Oil company)

*"There's a core of providers who understand the industry very well and also players with an history in the market who are coming back in with a new team and don't really have the credibility they previously had, and new players who don't understand it so well."* (Oil company)

The banks were seen as having the experience and understanding to play a lead role and get involved in early stage funding, but perceived as unlikely to want to be involved in higher risk financing.

*"It won't be easy for the banks to see a role in funding early stage, appraisal development unless they want to take mezzanine and equity type risks. If they want to become an all-stage provider that's a different issue, they've got the balance sheet to look at it but will they? I doubt it."* (Oil Company)

*"Why should they start to support a company that also does exploration when they know they have got a dozen fields producing in the North Sea … it never makes you feel the bank is fully supporting you."* (Oil company)

## Changes sought from financial markets to support the industry

While acknowledging that banks and other finance providers focused on needs of North Sea operators and made finance available, most respondents suggested changes, including more competition, more aggression and a greater willingness to develop higher-risk products to meet the changing needs of North Sea operators.

"*Need to work harder in terms of non plain vanilla products, based on individual projects. They perhaps don't move as quickly as they might say they do or that you might want them to."* (Oil company)

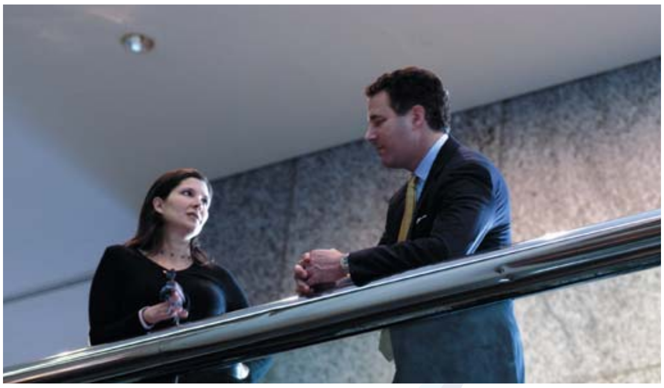
*"More finance that is not strictly senior debt and not strictly equity - there is room for more project finance and other types slightly riskier than debt but not as risky as equity type products. I think the banks are better set up to do that."* (Industry adviser)

*"The banks could be more aggressive; too often they're herded together in a pack and have similar prices and adopt a fairly conservative position. There's scope in the banking market to really go after business market share."* (Oil Company)

*"A better understanding of what is involved together with realistic lending vs. security models to ensure the right balance between idea encouragement and the capping of risk. Current lending criteria are risk averse i.e. no risk at all."* (Legal)

*"Stop using arbitrary and unwarrantedly conservative price assumptions that are well short of the forward curve by the banks in project finance, forcing poor hedging policies upon the lending company."* (Finance)

*"Greater flexibility in the position taken with regards financing overseas activities through the UK. As the scale of such activates grow, the financial products need to follow - at present they are not there in the UK in sufficient depth to permit sustained international development."* (Asset management)



# Further Direction

The North Sea Basin is part of an industry where opportunities and investment decisions are made in a global context and while more than seven out of ten (72%) surveyed worked in companies focused on the UK or Europe analysis of the long term focus indicates a net shift of nearly 20% away from the UK/Europe over the next five years, mainly to:

| | |
|---|---|
| Middle East | +5% |
| Russia / FSU | +4% |
| Africa | +3% |
| South America | +3% |
| Asia inc China & India | +3% |

*Source: on-line survey*

Our discussions with senior oil & gas industry executives reflected these variations. While most focused entirely or predominantly in the UK sector of the North Sea…

*"We focus entirely in the UK and see the rest of the world as competition for investment capital, physical and human resources."* (Oil Company)

…others also operated in Africa or more widely, including North America, with some driven by the operating location of their customers:

*"Africa is the great opportunity – our focus has always been to go where we can get a competitive edge outside of the majors where we can get a run in because we're not going to compete."* (Oil company)

*"We have a constant amount of overseas work. My aim would be to have two thirds UK and one third overseas."* (Industry adviser)

Over half of those surveyed (59%) thought an eventual exit from the North Sea is inevitable, most of whom thought it would occur after 2010, while 39% did not think it was inevitable.

## A shift in geographical focus away from the North Sea?

West Africa was the area most widely mentioned (by 44%) as benefiting from companies shifting their focus to other parts of the world, with North Africa, Russia and the Caspian Sea area each mentioned by just over a quarter.

| Which areas do you think will benefit from companies shifting their focus to other parts of the world? | |
|---|---|
| West Africa | 44% |
| North Africa | 29% |
| Russia | 29% |
| Caspian Sea area | 27% |
| Middle East | 20% |
| Eastern Europe | 17% |
| Central & South America | 11% |
| North America | 3% |
| Other | 6% |

*Source: on-line survey*

The reasons for this shift included lower production costs

*"Increasingly towards Africa, to add low-cost production from the development opportunity to go with our exploration position."* (Oil company)

as well as with differing growth rates rather than a deliberate change in focus

*"Wouldn't like to see the UK being less than 30% of our production, but it's not growing as fast as other areas as the incremental opportunities are slightly smaller or slightly more complex."* (Oil company)

*"The North Sea is the most important area in the globe for us (but) its importance will decline as some of the new areas come into fruition."* (Oil company)

while others mentioning better investment opportunities elsewhere:

*"We'll do much more in the US than we're likely to do in the UK; we may shift our focus further East; we've got people looking at some interesting things in Central Europe, an area that's relatively under-developed because of lack of investment."* (Finance)

## What will keep companies focused on the North Sea?

Nearly a quarter (22%) thought access to North Sea opportunities would prevent companies shifting their focus to other parts of the world – the fiscal regime (19%) and access to infrastructure (11%) were also mentioned by more than one in ten as reasons for companies maintaining their North sea focus.

What are the key reasons why North Sea companies will not shift their focus to other parts of the world?

| | |
|---|---|
| Access to opportunities | 22% |
| Fiscal regime | 19% |
| Access to infrastructure | 11% |
| Access to information | 7% |
| Qualification process | 4% |
| Other | 11% |

*Source: on-line survey*

## Survey Methodology:

The survey gathered information from three sources.

1. The conference registration form contained questions relating to current issues, geographic focus and predicted oil price. There were 416 completed responses.

2. A more detailed questionnaire was included on the registration form. There were 90 completed responses of this survey.

3. RBS commissioned an independent market research agency, Charterhouse Research, a specialist in business and financial research, to conduct in-depth one to one interviews with senior indus try executives. We are grateful to the ten executives who gave their time to this project.

Analysis of the questionnaire and interviews has been undertaken by Charterhouse Research and the RBS in-house market research team.

All responses are confidential and anonymous.

This study was undertaken between September and November 2005 and was completed before the Chancellor of the Exchequer's 2005 Pre-Budget Report announcing changes to the taxation regime.

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