CLIFFORD CHANCE

Briefing note

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# Oil Prices: Cause and Effect

The global price of oil had been relatively stable at about US$110 a barrel for the last 4-5 years. However, the increased shale oil production in the US combined with lower global demand for oil has recently led to a plunge in oil prices. Oil prices have fallen significantly since June 2014.

The decline, together with uncertainty about where oil prices will settle, has created sudden downward pressure in the oil & gas sector and has given rise to a need to re-visit business planning and strategy, at least in the short term. Some of the key themes that we have seen and expect to continue with the increased volatility in oil prices are set out below.

## Key issues

- Impact on oil exporting countries
- Review of current project arrangements
- Long term LNG contracts against a strengthening US dollar
- Merger and acquisition opportunities

## Impact on oil exporting countries

The fall in oil prices will have a significant impact on countries (like Venezuela, Nigeria and Russia) for which oil exports make up a large proportion of their income.

Venezuela, which was already suffering the effects of inflation, will likely need prices of US$120 per barrel if it is to fund important social programmes and Nigeria has had to devalue its currency as a result of the falling oil prices. Russia's woes are well documented – it has announced that it will no longer proceed with the South Stream gas pipeline project, the rouble has fallen dramatically amid continued falling oil prices and the effect of sanctions and its 2015 budget, which was based on oil prices of US$100 per barrel, is being re-evaluated.

If oil prices continue to fall, or stay at the current levels for a sustained period, this could lead to:

- significant budget deficits
- defaults by oil-producing countries in their contractual obligations
- debt and loan defaults
- sovereign debt refinancing
- oil-producing countries seeking to increase their "take" of revenue under petroleum agreements at the expense of oil companies, including through expropriative actions

It would be prudent to consider what provisions should be included in future contracts with sovereign states as protection from the relevant risks. Bilateral or multilateral investment treaties could prove very useful in reducing expropriation risk.

A further consequence for "petro-dollar" countries or emirates (such as Qatar, Abu Dhabi, etc.) with sale contracts benchmarked against the price of oil in US dollars is that their net proceeds will be diminished. This may lead to a curbing in the funding of sovereign wealth funds and their international investment plans. The acquisition of non-core assets like football clubs may also become less common. The Institute of International Finance estimates that the flow of petrodollars which was estimated at US$500 billion in 2012 may fall to US$100 billion in 2015 if oil prices are below US$78 a barrel.

In a lower oil price environment, oil-producing countries will come under increasing pressure to offer more attractive fiscal terms, starting with countries with high marginal cost fields. On 22 January 2015, for example, the UK government announced a consultation to support investment in North Sea oil and gas

projects through the introduction of a single basin-wide investment allowance. This came on the heels of a reduction on 1 January 2015 of the "supplementary charge" assessed on oil companies' adjusted ring fence profits from 32% to 30%. These changes were driven largely by concerns that low oil prices could permanently damage North Sea production, which already faces some of the world's highest production costs and, increasingly, high decommissioning expenses.

## Review of current project arrangements

With oil and gas producers as well as sovereigns reviewing their balance sheets and spending plans in light of the lower oil and gas prices, this could lead to a number of projects which are anticipated to be sustainable only at higher oil prices being restructured, scaled down, slowed down or even abandoned.

This is particularly so in relation to projects in "new frontier" regions like the Arctic and east Africa. We have seen examples of this most recently in the announcements that Statoil are looking to delay development of its Johan Castberg project, Chevron putting on hold its plans to drill in the Beaufort Sea and Statoil, Dong Energy and GDF Suez all handing back licences for oil exploration off Greenland. Energy Aspects, a London-based consultancy, estimates that more than 12% of global oil production would be uneconomic at current oil prices.

We expect the lower oil prices to result in companies:

- actively looking to restructure their existing projects
- being more selective with their new investments - investment in projects only being sanctioned if they are viable at an oil price under US$70 per barrel
- stress testing the terms of their existing supply contracts
- refinancing their debt in relation to projects
- exerting pressure on oilfield service contractors and other suppliers to reduce prices

## Long-term LNG contracts against a strengthening US dollar

LNG contracts are typically long-term contracts and traditionally linked to oil prices. In Asia, where LNG demand accounted for three-quarters of global demand last year, the higher oil prices over the last 4-5 years had increased the cost of importing oil-linked LNG for Asian utilities which have not been able to pass on the higher cost to end-users. US LNG exports to Asia based on the Henry Hub gas price index are becoming more frequent, but this index has a history of volatility, caused by the extremes in North America weather. LNG buyers in Asia have, as a result, been seeking to develop a viable alternative pricing mechanism to create a stable "Asian" LNG pricing mechanism. Although the fall in oil prices could make oil-linked LNG contracts attractive, this assumes that oil prices will be sustained in the long term at the lower level, which may not be likely.

In order for Asia to develop a stable and reliable Asian pricing index, it is important that there are deregulated markets (including in natural gas upstream, transportation and trading), a transparent market with limited government intervention or scope for abuse, an interconnected gas transmission pipeline system and a large and efficient short term and futures market with buyers and sellers competing for positions.

## Merger and acquisition opportunities

Volatility in oil prices has traditionally resulted in increased M&A activity in certain areas.

Assets will come onto the market as companies look to review their portfolio and dispose of their less profitable assets. For example, Total recently announced that it plans to accelerate its 2015-2017 assets sale programme of US$10 billion by disposing of US$5 billion of assets in 2015.

We also expect M&A activity and consolidation in relation to small and medium sized companies. Low prices could put these companies into a "distressed situation" that forces them to either sell assets to raise cash or make such companies attractive and cheap targets for opportunistic buyers. We would also expect such small and medium sized companies to look to merge and consolidate with each other. The recommended offer by Ophir Energy for Salamander Energy which was announced in November 2014 may be a sign of other such deals to come.

The oilfield services industry which, as noted above, suffers when low prices reduce oil company spending, has also seen some significant activity. In November 2014, the second-largest oil-field service company, Halliburton Co., bid about US$35bn to acquire No. 3 Baker Hughes. France's Technip also bid in the same month for a smaller services firm, offering US$1.83 billion to buy Paris-based CGG.

We have seen private equity investment in the sector increase during the last 4-5 years of high stable oil prices. With the lower oil prices hitting their anticipated return on investment, private equity players may be facing their first real exposure to the volatility of the sector and start to re-evaluate their investments in this sector, resulting in possible disposals.

Conversely, low oil prices also present investment opportunities in the oil and gas sector. Carlyle has indicated that it intends to raise between US$3-4 billion this year for energy investments to add to the US$9 billion it has earmarked for this purpose.

Finally, we may also see some significant M&A transactions by major oil companies with significant liquidity. The acquisitions by BP of Amoco, Chevron of Texaco and Exxon of Mobil in the 1990s were made at a time of low oil prices.

While no one can accurately predict the price of oil going forward, 2015 is likely to see some continued challenges and new opportunities in the oil and gas sector.

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