



Mid-year Review (2009): Sharp Turns Ahead

Supporting critical Oil & Gas industry decisions: Strategy, organisation, operations, technology and mergers & acquisitions

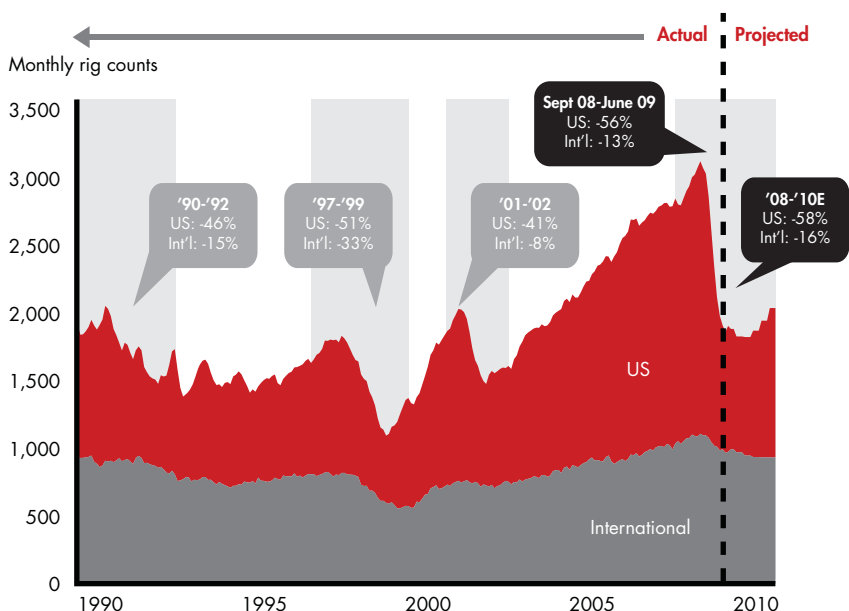
The second half of 2009 will test the Oil & Gas industry in new ways. As the global economy resets nervously, the only certainty is that crude oil prices will remain volatile. After dipping to a low \$33/barrel last December, oil prices strengthened dramatically in the second quarter of 2009, peaking at just over \$73/barrel in June—faster than many in the industry expected. While higher prices led to much lower but still reasonable earnings in the first six months of 2009, oil companies have cause for concern: if prices rise too fast they could slow the global recovery and stall progress on resetting industry costs. In addition, they face hard investment decisions. On the one hand, they must continue to cut costs without compromising on important areas like maintenance, technology and people development. On the other, they must invest in large-scale capital projects to replace declining assets and increase future revenue growth.

The scale and scope of the 2008–2009 global recession (See Figure 1) has already affected some projects. In the US, drilling activity has dropped rapidly

In practical terms, Oil & Gas industry leaders must address three questions in the next few months:

- At what point do we switch the emphasis from cutting costs to ramping up investments for the future?
- In a volatile price environment, what should we assume about the future of oil prices to make investment decisions?
- If oil prices do indeed settle at around \$60–\$70/barrel for the rest of 2009, how should we deploy the additional gross revenues?

Figure 1: The scale of this downturn surpasses others in the past 20 years—but it is not unprecedented



Note: 2008–2009 decline is through July 2009; decline 2008–2010 is projected; declines calculated peak to trough
Source: Baker Hughes rig counts; Credit Suisse (3/12/2009) and JP Morgan (3/4/2009) projections

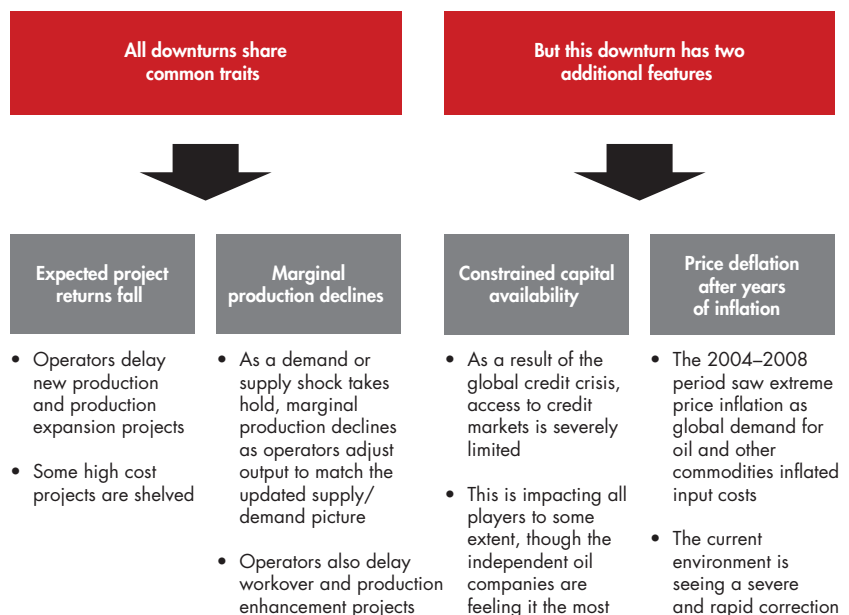
For investments in upstream oil projects, Bain estimates the tipping point is around \$65/barrel—at that point the industry’s need to contain costs is overtaken by the desire to expand and grow.

in Texas and Louisiana. In unconventional Oil & Gas exploration, areas such as tight natural gas extraction and shale oil production remain depressed, and gas prices continue to show signs of decoupling from the trend in oil prices. The stalling of some expansion plans in conventional Oil & Gas and the slowdown in the hunt for new reserves could mean that oil production capacity declines from historic highs by about 3 million to 5 million barrels by the end of 2010. That in turn will further add to the volatility in oil prices when demand in major markets eventually picks up in North America, China and India.

In these circumstances, oil company leaders face tough choices (See Figure 2.) Making the right decision at the right time will have huge pay-off for the winners. Get the timing wrong and a company could miss the window of opportunity to secure or improve its industry ranking. Those companies that have built up reserves and have a strong projects pipeline will be in a prime position to capture new opportunities—others will either watch from the sidelines or be swallowed up in the industry churn. In practical terms, Oil & Gas industry leaders must address three questions in the next few months:

- At what point do we switch the emphasis from cutting costs to ramping up investing in the future? Bain estimates that in the first six months of 2009, the Oil & Gas industry cut expenses by 20 per cent compared with 2008,

Figure 2: Investments in exploration and production are currently constrained by several factors



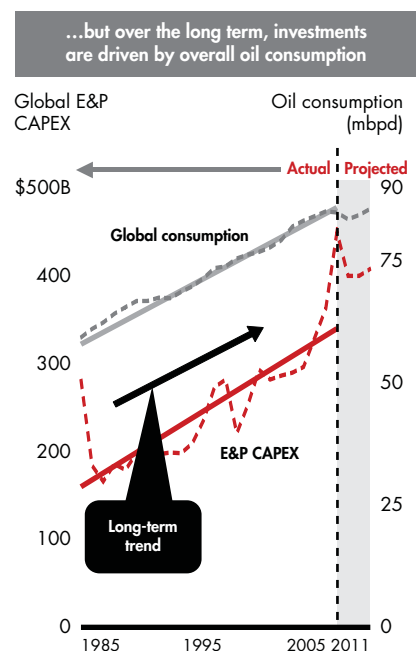
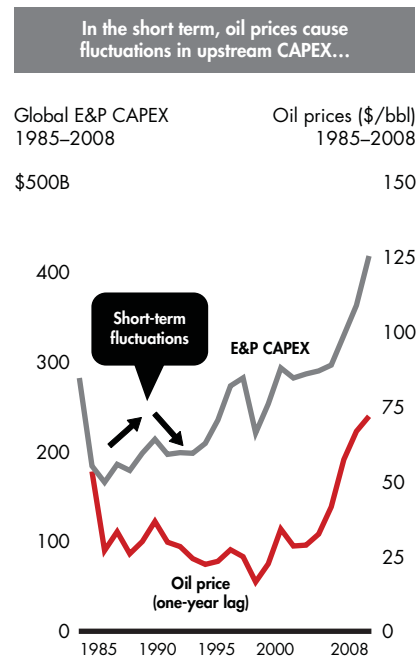
mostly by reducing activity, putting pressure on suppliers and squeezing operational costs. Looking ahead, as companies review plans and budgets for 2010, they must find the balance between managing costs and sustaining—even expanding—activity levels.

- In a volatile price environment, what should we assume about the future of oil prices to make investment decisions? Some companies reckon oil prices will stabilise in the \$40–\$50/barrel range; others expect prices to rise to \$70–\$80/barrel. Bain estimates that for upstream oil projects, the tipping point is around \$65/barrel—at that point the industry’s need to contain costs is overtaken by the desire to expand and grow. Making the right call is essential in the second half of 2009 while planning new exploration, development and production expansion projects for 2010.
- If oil prices do indeed settle at around \$60–\$70/barrel for the rest of 2009 and into 2010, the multi-billion-dollar question will be: how should we deploy the additional gross revenues? The upstream Oil & Gas industry is a strong cash generator when prices climb above marginal production cost. If oil prices remain above \$60/barrel over the next two quarters, by early 2010, the industry could be looking at additional cash income in excess of \$100 billion. In recent years windfall profits were generally returned to shareholders in the form of dividends and buybacks. The last twelve months have made the decision on how to spend the money much more complex: invest for the long term, invest in a strategic acquisition, or abdicate the decision to shareholders?

For service companies, there is an added twist: How do we handle the pressure from Oil & Gas customers? After a rough ride—where oil majors used every technique for cutting costs, from hard-talk to renegotiating contracts for equipments and services—some in the service sector may be breathing a collective sigh of relief as oil prices recover. However, Bain’s research shows that oil companies are determined to extract even more savings from suppliers and in fact, most plan to lock in new terms and conditions before the industry’s fortunes turn for the better. For example, western service companies will have to find lower cost, inventive and fresh ways to serve the needs of demanding Oil & Gas customers if they are not to lose market share to eastern suppliers.

Despite the challenges, some leading industry players can gain competitive ground in the next few months by planning steady organic growth as well as pursuing thoughtful mergers and acquisitions. In terms of the former, for example, there are encouraging signs that the industry will benefit from the exploration efforts of recent years. These have resulted in exciting discoveries in new areas like Ghana and Uganda, potential production increases in Brazil and

Figure 3: After a downturn, as activity levels rise, investments resume their historical growth pattern



Source: BP statistical review (June 2008); Lehman Brothers The Original E&P Spending Survey (June 2008); EIA Short-Term Energy Outlook (March 2009)

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even rejuvenated hope in mature basins—the biggest discovery in thirty-five years in California was just announced this July. After the downturn, as the industry reverts to a more historical growth pattern (See Figure 3.), exploration activity will intensify rapidly but the places where basins will make the top of the investment priority list may look very different from the places in 2007.

With many Oil & Gas company valuations still low versus historic highs and current oil prices, aggressive buyers in the industry should move into action in the second half of 2009. Bain estimates as many as 10 per cent of the top 300 Oil & Gas companies could be snapped up by a competitor in the next twelve months—and the first signs of industry consolidation are already visible in many regions. With private equity funds and strategic investors also starting to show interest in the Oil & Gas sector lately, there is one more reason to believe that deals in the industry are about to take off in the second half of 2009.

However chaotic the game might have been so far, at half-time in 2009, leading Oil & Gas CEOs are prepared to go on the offensive as well as defend their company position. Their top priorities: ranking existing production assets by marginal cost, developing a clear plan for replenishing reserves and winning major development projects, identifying the best geographic fit for expansions within their existing portfolio—and finally, aggressively prospecting for growth, both organic and through acquisitions and alliances.

For more information, please visit www.bain.com

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