

Catalytic converter

Five themes from oil majors' 2015 updates

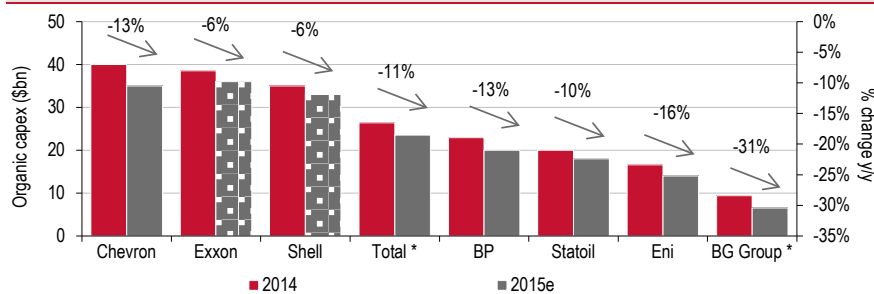
25 February 2015

As the Big Oil year-end 2014 reporting season draws to an end, we reflect on the main messages from the strategy updates. Based on current guidance, majors' organic capex is set to fall around 13% in 2015, after four straight years of capex hikes. Spend could drop more as service costs are seen declining 20-30% from their 2014 peak. Exploration and pre-FID projects – notably expensive, complex projects such as deepwater, LNG and oil sands – are prime targets for investment cuts. Base capex in high-cost regions is also being trimmed, which should accelerate global decline rates. Majors appear keener on divestments than acquisitions for now, but we would expect to see opportunistic mid-sized asset deals. In our view, Big Oil's focus on dividends may be preventing managements from acting more countercyclically in a downturn.

Theme 1: Double-digit capex cuts in 2015

Unsurprisingly, the number 1 theme to emerge from the European and US majors' full-year 2014 results presentations/annual strategy updates was the reduction in capital expenditures for 2015. Capex cuts for the group were broadly in line with expectations, coming in at c 13% y/y on average and c 15% vs previous guidance (which assumed small capex hikes). The biggest y-o-y declines in percentage terms were at BG, Eni and BP with 13-31% cuts. By contrast, well-capitalised supermajors Shell and Exxon expressed a desire to not "overreact" to lower oil prices, and are likely to reduce 2015 spend only by mid- or high single digits.

Exhibit 1: Integrated Oils' organic capex guidance for 2015e



Source: Edison Investment Research, company data. Note: *Mid-point of guidance range. Exxon's and Shell's 2015e capex are our assumptions based on company guidance.

Key areas of capex reductions include:

- **exploration and access spend**, expected to be down 10-30% y-o-y;
 - **unsanctioned projects**, particularly complex deepwater and LNG projects, where there is scope for material cost reductions in the current downcycle, either through re-engineering or renegotiating with suppliers (eg BP's Mad Dog Phase 2 in the Gulf of Mexico). These projects could come back in a year's time if the majors are successful at reducing construction costs;
- (continued overleaf)*

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- **high-cost marginal projects** that are no longer economic at lower oil prices and put on a long backburner, such as Canadian oil sands and greenfield LNG in Australia and Canada. This may appear contradictory with majors' insistence that they continue to assess and sanction projects based on an unchanged base case of \$80-90/bbl, even through the recent period of \$110/bbl oil. Delays to LNG projects may reflect Asian buyers' unwillingness to sign long-term sales agreements while LNG pricing remains fluid;
- **short-cycle projects** such as in-fill wells or tie-backs with six-month to two-year paybacks that no longer work at the current near-term forward curve. This particularly affects mature regions such as North Sea, but also West Africa and the Gulf of Mexico; and
- **US tight/shale** oil and gas drilling, especially outside core liquids-rich areas.

In our view, variances in the size of capex cuts is explained mainly by: a) balance sheet strength (current and forecast); b) capex flexibility and biases towards long-cycle projects at the likes of Shell and Chevron (eg LNG/oil sands) vs biases for smaller, short-cycle projects at majors like Statoil and Eni. Projects already in construction (eg Gorgon, Ichthys) cannot be put on hold at this stage, while small infill wells, tie-backs and unsanctioned projects can be postponed more easily. As a rule of thumb, around 90% of majors' capex is already committed one year forward, with the proportion falling to 65-70% two years out and 40-50% three years out.

Exhibit 2: European and US Majors' 2015 capex guidance

Company	2014	2015e	Y-o-y change	Previous guidance	% change	Comments
Shell	35	33	-6%			<ul style="list-style-type: none"> 2015 is our assumption. \$15bn cut over 2015-17, no 2015 guidance. 40 projects postponed. Carmon Creek Phase 3-4 (Canada oil sands), Majnoon (Iraq), Nigeria, Arrow LNG, Abadi, Browse LNG, LNG Canada.
BP	22.9	20	-13%	25*	-20%	<ul style="list-style-type: none"> Cutting exploration & access spend, marginal projects, postponing of FIDs (eg Mad Dog Phase 2, Canadian heavy oil expansions). No "drastic" capex reductions in Lower 48 onshore. Maintaining high-return infill drilling.
BG Group	9.4	6.5*	-31%	9*	-28%	<ul style="list-style-type: none"> Reducing base capex by 50% in UK, Egypt, T&T, Kazakhstan, US shale. Exploration spend flat, but focus on seismic, rather than drilling. Delaying Tanzania and Lake Charles LNG.
Total	26.4	23.5*	-11%	25.5*	-8%	<ul style="list-style-type: none"> Exploration capex is cut 30%. Delays to US shale oil, greenfield offshore West Africa, pre-salt Brazil. Cutting brownfield in West Africa and North Sea. No FIDs in 2015.
Eni	16.6	14	-16%			<ul style="list-style-type: none"> Cuts in Downstream/G&P, exploration and complex projects. No cuts to base capex. Will FID Mozambique LNG + Angola, Congo offshore projects.
Statoil	20	18	-10%	20	-10%	<ul style="list-style-type: none"> Flat exploration spend. Delaying Corner (Canada oil sands), cutting Bakken/Eagle Ford rig count, delaying Johan Castberg. Will FID Johan Sverdrup.
Chevron	40	35	-13%	40	-13%	<ul style="list-style-type: none"> Cutting short-cycle base capex, exploration spend down 10-15%, LNG capex down 20%, Deepwater spend relatively flat y-o-y (mostly contracted), Shale/tight spend actually a little higher. Delayed Kitimat LNG. FID only one project: Tengiz.
Exxon	38.5	36	-6%			<ul style="list-style-type: none"> 2015 is our assumption. "under \$37bn in 2015" but no firm capex guidance yet – to be given at March analyst day.
Weighted average	208.8	186	-11%	103	-14%	
Arithmetic average			-13%		-16%	

Source: Edison Investment Research, company data. Note:*Mid-point of guidance range.

Majors have embedded either no or minor cost reductions from suppliers in their 2015 capex guidance. If service costs fall faster than companies' assumptions, 2015 capex budgets may well end up below current guidance. Alternatively, activity levels could be flatter if majors are able to get more from their suppliers out of each dollar spent.

Strategic differences highlight varying asset quality

Besides the severity of capex cuts, noteworthy differences are emerging between the majors' strategies. Sweeping generalisations are useful, but mask interesting variances in asset quality in project categories such as LNG, shale, deepwater, etc.

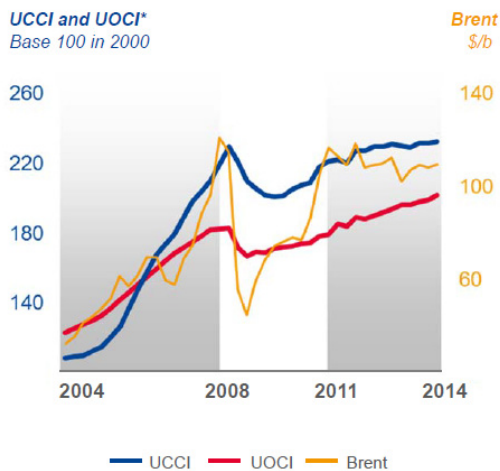
- Statoil and BG are the only two majors not to cut exploration budgets, although BG is prioritising prospect generation through seismic rather than exploratory drilling this year. The exploration focus at Statoil and BG may be explained to their DNA as “mega-E&Ps” rather than classic integrated oil companies.
- While most Majors will reduce “base” capex (ex-safety and maintenance), Eni and BP intend to maintain flat spending on their base assets as they continue to see very high returns even at lower oil prices. We suspect this is due to the low-complexity and often onshore nature of Eni's producing base in North and West Africa, and the relative youth of BP's producing assets. Overall, lower base spend is likely to accelerate decline rates in the majors' legacy portfolios from the current 4-5% pa.
- Some majors such as Total and Chevron are essentially freezing most project sanctions in 2015, whereas others, eg Eni and Statoil, still see scope to FID projects this year. The latter includes even big-ticket projects, eg Mozambique LNG (at least the Floating LNG element) and the giant Johan Sverdrup, whose development plan was submitted in mid-February. In our view, the ability to sanction projects now without delaying/recycling them further is largely due to lower break-evens and better through-cycle economics. It should be no surprise that Mozambique LNG, which sits at the lower end of the global LNG cost curve, could be launched this year while more expensive greenfield Australian and Canadian LNG projects are postponed. It remains to be seen whether US LNG export schemes will slow down to the same extent as more expensive Canadian or Australian projects.
- Chevron is planning to maintain or slightly increase US shale/tight investment, given the strong returns it sees in its Permian assets. This is in contrast to European majors (particularly Total and Statoil), which generally sit on lower-quality shale assets compared to their US peers and are cutting back on US shale capex.

Theme 2: Cost savings, efficiency and supply chain

Service costs to fall: majors see significant opportunities to reduce costs throughout the value chain, both in terms of their own internal cost bases and suppliers' costs. However, cost deflation in the supply chain typically takes **6-18 months to flow through to majors' capex budgets**, given the amount of committed capex, eg on rigs and projects in construction. Service contract renegotiations started in late 2014 and are still in early stages.

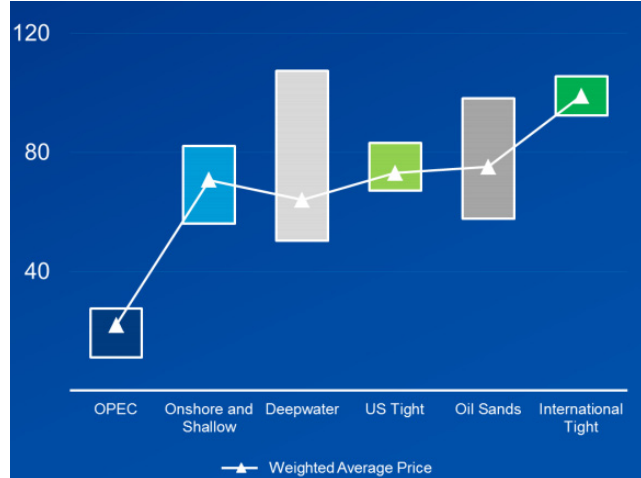
Majors are expecting **cost reductions of the order of 20-30%** over time, based on previous cycles. Cost deflation should be visible first in drilling rigs and seismic, while offshore equipment and installation will take longer to react as contractors complete work on their backlogs. Regionally, the US onshore will almost certainly be more reactive than other regions given shale's short-cycle nature. We would not be surprised to see all majors attempting to lock in lower service costs at the same time in 6-12 months, leading to a sharp recovery in service pricing.

Exhibit 3: In the 2008-09 downturn, service costs fell 10-20% on average. How much will they fall this time?



Source: Total September 2014 Investor Day, IHS CERA.
Note: *Capital Cost Index and Upstream Operating Cost Index.

Exhibit 4: Oil price break-even by asset class. Many projects do not work at \$70-80/bbl Brent



Source: Chevron March 2014 Analyst Day, Wood Mackenzie

Tax breaks? Majors are also hoping for tax breaks in high-cost or highly taxed regions (eg Norway, the UK, and likely MENA and West African countries) to help cushion lower oil prices. Majors' line of argument is that tax breaks should spur oil and gas investment and ultimately protect tax revenues for host governments and countries. However, if history is a guide, temporary tax hikes are rarely reversed. With the possible exception of the UK, we see these statements more as managements' wishful thinking than a realistic aspiration.

Self-help is the order of the day: companies see the current environment as a chance to improve their own cost competitiveness and efficiency. Nearly all majors have given quantified opex reduction targets, typically of the order of 10-15%, through a combination of staff reductions and efficiency initiatives. Some of these efficiencies are related to getting more production out of the ground, eg by reducing unplanned downtime, ie essentially cutting unit production costs rather than absolute costs. These messages and targets very much echo those given during the 2009 oil price downturn.

Theme 3: Dividends remain the priority; buybacks cut

Similar to previous downturns, the integrated oils are prioritising dividends over other uses of cash in their financial frameworks. At all majors, dividends were kept flat for 2015 despite lower cash generation, with free cash neutrality (post dividend) expected by company managements to return by 2017 at \$70-80/bbl.

Total introduced a scrip dividend for the first time in its history, which could improve financial flexibility. Meanwhile, the pace of buybacks at BP and Shell trickled to a halt by late 2014. Chevron has dropped its \$5bn annual buyback altogether for 2015, and Exxon has cut its quarterly buyback programme from \$3bn to \$1bn.

Theme 4: M&A strategy – if majors are not countercyclical, who can be?

- Acquisitions not the priority for now:** from their language on Q414 conference calls, majors appear more keen on divesting assets than buying assets. Ongoing divestments are used to high-grade asset portfolios, but in this environment they are also part of majors' toolbox to protect their balance sheets. As of early February (as the oil price had just stabilised), BP management stated it was "a little early" to look at acquisitions of distressed assets. Needless to say, such statements need to be taken with a pinch of salt as managements rarely advertise their true intentions. We do see potential for majors to opportunistically pick up assets or

acquire small-cap E&Ps, either to reinforce their presence in existing areas, or as a way to enter new regions such as North American shale or international exploration hotspots. We recall that in 2008-10 Total, Statoil, BP and others acquired “resource plays” and pre-appraisal discoveries, including North American shale, Canadian oil sands, Australian gas, Brazil deepwater, etc. However, we are more sceptical about large-scale M&A.

- **Still in “shrink-to-grow” mode:** Shell, BP and Total are each targeting c \$5bn of divestments in 2015 and CVX is targeting \$4bn over 2015-16. Majors’ disposals target may be difficult to achieve this year as many buyers lack financing capacity, something that Shell management has openly acknowledged. It seems to us that only Asian and Middle-Eastern NOCs could still be in a position to buy assets from the majors these days. The integrated oils are divesting mostly “non-core” assets, including mid-/downstream assets and mature fields. Bucking the trend, BP also looks to divest early-life upstream assets, whose prices should be less dependent on oil price fluctuations than producing fields.

Theme 5: Impairments – accounting rules leave room for interpretation

Majors booked a combined >\$24bn of impairments in Q414 on the back of lower oil prices, largely (c 90%) in upstream. BP, Total, and BG each took around \$6bn of impairments, Statoil \$3bn and Eni \$1.3bn. By contrast, Shell, Exxon and Chevron chose not to book large impairments, arguing that their long-term oil price views were unchanged.

Importantly, companies have some leeway to determine impairments under accounting rules.

- Under IFRS, companies have to compare the carrying value of their assets with the expected future cash flows or resale value of the assets. In this process, they can choose to use either their internal assumptions or forward curves. For short-term projects (eg infill offshore wells, shale wells), two-year forward curves are presumably more appropriate than internal assumptions. This explains why North Sea assets and lower-quality US shale assets have been impaired at lower oil and gas prices. Longer-term projects starting up in 2020+ may not see their value impaired at all, if they are still believed to be going ahead at some stage. Conversely, projects put on an indefinite backburner would have to be impaired.
- Impairment tests typically have to be triggered by an identifiable “event”. A decline in commodity prices is not necessarily considered to be a trigger event in itself; however, a downgrade to reserves (which may be caused by lower prices) may be a sufficient trigger.

Exhibit 5: Majors’ Q414 impairments

Company	\$bn	Comments
Shell	0.3	No change to long-term oil price view. Still planning on \$90/bbl Brent long term, low case \$70, high case \$110.
BP	6.5	North Sea, Angola. Sanctioning projects at \$80/bbl long term, testing down at \$60/bbl – unchanged.
BG Group	5.9	Egypt (poor reservoir performance, Egypt LNG written off) and QCLNG, to a lesser extent in Tunisia, North Sea and US.
Total	6.5	\$2.2bn in Canadian oil sands, \$2.1bn in US shale gas, \$1.4bn in European refining and other E&P assets.
Eni	1.3	E&P assets, mainly driven by lower prices in near/mid-term.
Statoil	3.0	50% on US onshore, rest on Canadian SAGD project, exploration assets in Angola, Gulf of Mexico.
Chevron	0.7	Small US assets, several late in life assets in international.
Exxon	N/A	
Total	24.2	

Source: Edison Investment Research, company data

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