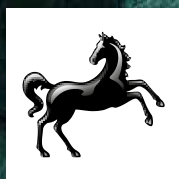
COMMERCIAL BANKING

LLOYDS BANK RESEARCH SERIES – OIL & GAS

Re-evaluating Strategies

2016



LLOYDS BANK

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FOREWORD

Colin Butcher
Managing Director, Oil & Gas, Lloyds Bank Commercial Banking

Welcome to the fifth annual Lloyds Banking Group oil and gas sector report. Clearly the last year has been an exceptionally challenging one for the industry, and at a time when so many firms are having to plan and take reactive measures, I hope that our findings will prove especially valuable.

The decline in the price of oil has made headlines around the world, and its knock-on impact on investment and employment has created economic headwinds that are being felt, not just by the industry but across the wider economy.

At the time of writing, the price of oil was hovering around $50/barrel, and the hope is that prices have bottomed out and have begun to slowly and modestly recover. No one has a crystal ball, but when asked about oil prices, the majority of our respondents anticipate "lower for longer" pricing and don't expect Brent crude to recover to a sustained level of $75-80/barrel until 2020 or later.

Though there are undoubtedly more difficult decisions to be taken on cost savings, jobs and investment, cautious optimism for the future outlook appears to be slowly returning.

We don't want to downplay the impact of the depressed oil prices – for many larger businesses the blow has been severe.

A quarter of the firms surveyed told us they had grown through the downturn. They have taken the opportunity to diversify into new sectors and markets, collaborate with other firms, invest in new technology and innovate, and these actions will help create an industry that is far more efficient and resilient in the future.

We don't want to downplay the impact of depressed oil prices – for many businesses the blow has been severe, and for the many individuals who have lost their jobs it has been hugely difficult - however, at this tough time, the oil and gas sector is proving itself to be among the most entrepreneurial, innovative and resilient industries in Britain.

There are still choppy waters to navigate and at Lloyds Bank Commercial Banking we remain committed to supporting the oil and gas sector as it continues on this difficult journey.

EXECUTIVE SUMMARY

The way through the present bad times involves still more harsh decisions.

The outlook for the oil and gas industry looks extremely challenging – investment significantly reduced, projects cancelled and deferred, jobs being cut – and all because of a product price that is about half of what it was two years ago.

This year's Lloyds Banking Group survey of decision makers from 141 oil and gas companies across Scotland, England and Wales, ranging from producers to suppliers down the supply chain, has found that, while the short term outlook is understandably very gloomy, there are some potential silver linings. The general message from the industry is that the way through the present bad times involves still more harsh decisions, including further substantial cost cutting, but a sustainable future and even some growth, albeit patchy, is within reach. Getting there and staying there, however, will involve immense hard work and discipline.

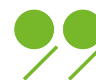
Current price challenges need to be set in a broader historical context. The years of $100+/barrel were a half-decade price bubble in a much longer run of prices which, in real terms, have ranged between $30-40/barrel. So 2015's slide from a high of $69 in May to $36 by the year-end, and even to a low of $28 in January 2016, is not quite as unusual as it may first seem. It is, moreover, a normal that prevailed for nearly two decades, during which the North Sea industry did not just survive, but thrived, grew, expanded production to a peak in 1999, and made profits. Higher costs and the much greater maturity of the province mean profits are much harder to realise now, but much of the industry clearly thinks they are still attainable.

Nevertheless, 2015 has been a major shock. A sizeable proportion, but still less than half (41%) of all firms say they have been affected severely or quite badly by the price fall (7% say severely) but that is partially offset by the 25 per cent who say they have experienced a positive impact. However, the impact has been much worse on large companies turning over more than £750 million, among which 19 per cent say they have been severely affected and 48 per cent quite badly affected.

As these are also major employers, this is obviously damaging for North Sea employment. The sharp downturn in exploration and field development work has hit subsea firms (80% badly or severely affected) and drilling companies (75% badly or severely affected) worst of all, but only 19 per cent of exploration and production companies said they have been badly affected (none severely), perhaps because many have been cushioned by the hedging of forward sales, which tops up revenues. Companies in Scotland have felt the chill more sharply than in England and Wales – 57 per cent say they have been severely or badly affected.

The employment impact is explored later in this report. But an indication that employment has borne the brunt of the price slump comes in the descriptions given by executives of how their business has changed in the last year. More than half (58%) say they have either implemented efficiency measures or reduced costs. Nearly two-thirds (66%) of small companies have taken these actions. But there have been compensating positive actions. More than a third (38%) said they had grown, through diversification (22%), organically (10%) or by merger and/or acquisitions (6%).

Opinions about the ability to continue trading vary by company size, with mid-sized and large firms the most uncertain.



41%

of businesses have been severely or badly affected by the oil price

56%

of Scottish businesses expect that there is still more to be done to survive the downturn

Understandably, media focus on job cuts has taken precedence and obscured the fact that companies have also been taking other remedial actions to become more resilient in a low-price environment. Focusing on the actions of the two-fifths of companies that said they had been severely or badly affected by the price fall, the most common strategies have been to collaborate with other firms (57%), to look to international markets (55%), and to diversify (40%). There has also been investment in new technologies (28%) and in research and development (24%). More defensive actions have included disposal of assets (28%) and even of business divisions (22%). Less emphasis has been given to financial tactics such as seeking corporate finance expertise to help with mergers and acquisitions (22%), agreeing new cash flow finance products (26%), or agreeing more support from banks (12%).

Responses to low prices do vary between large and small firms. Large firms are potentially most likely to have collaborated with other businesses (64%), much more likely to have agreed new cash flow finance products (50%) and to have sold an area of the business (36%), an indication that large firms are under the most pressure. Mid-sized firms have been more interested in international markets (72%), in diversification (50%) and in research and development (33%). Smaller firms of less than £25 million turnover have been most receptive to investment in new technology (31%) in the past 12 months.

Among the 41 per cent of all companies severely or badly affected by the price fall, only 40 per cent think they have done all they can, or at least enough to survive the downturn, while 43 per cent think there is more to do.

Opinions about the ability to continue trading vary by company size, with mid-sized and large firms the most uncertain. Again, companies based in Scotland are under most pressure, with 56 per cent expecting that there is still more to be done.

Despite the uncertainty, about nine in ten (91%) of the severely or badly affected firms feel they have enough knowledge and expertise within their business to deal with the low-price environment. Another outcome for businesses that plan to scale back or make efficiency measures to improve profitability in the next 12 months (48%), and those that have done so in the previous 12 months (58%), is that in order to survive, the industry has become leaner, more agile and efficient, which will set it in a more competitive and sustainable position for the future.

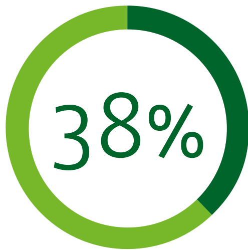
The same rather equivocal view is reflected in feelings about the year ahead. About the same number of companies feel optimistic (30%) as feel pessimistic (28%). Gloom, however, is pervading large companies. For every two feeling optimistic, there are five feeling pessimistic. In contrast, for every three smaller firms expressing optimism, there are only two pessimists.

Mid-sized firms edge towards optimism: for every five pessimists there are six optimists. The sharp downturn in exploration and field development explains overall pessimism amongst subsea specialists, drilling companies, constructors, and marine services. A positive note is that for every three pessimistic exploration and production companies, there are five optimists. Equipment suppliers and logistics companies are also mainly optimists.

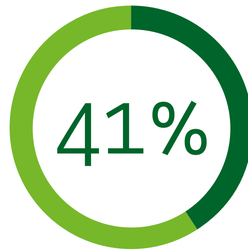
But 42 per cent of all companies were unable to decide either way, indicative of the huge uncertainty hanging over the industry.

KEY FINDINGS

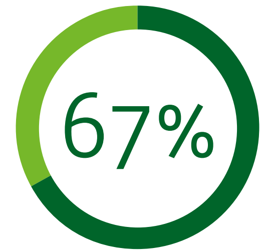
THE PRICE FALL



think the price will return to $75-$80/barrel between 2020 and 2022



of all companies say they have been affected either severely or quite badly



of large companies said they had been severely or quite badly affected

RE-EVALUATING STRATEGIES

18%

expect to reduce operating costs in the next 12 months

30%

expect to make more efficiency measures

30%

hope to grow through diversifying

EMPLOYMENT

51%

of all companies have had to cut jobs in the past 12 months

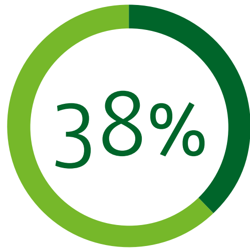
63%

of Scottish companies have had to cut jobs in the past 6 months

1

job was created for every 6 lost

THE YEAR AHEAD



expect Brent crude to recover to $75-80/barrel in 2020 or later

Last year's survey, carried out when the oil price was around $50/barrel and predicted by most analysts to rise to between $65-75/barrel by the year-end, found that nine out of ten companies planned expansion, either organically or through mergers and acquisitions. The expectation of a recovery and a return to levels above $100/barrel was not unreasonable as price declines since 1986 have generally not lasted longer than 160 days before an upturn has arrived[1].

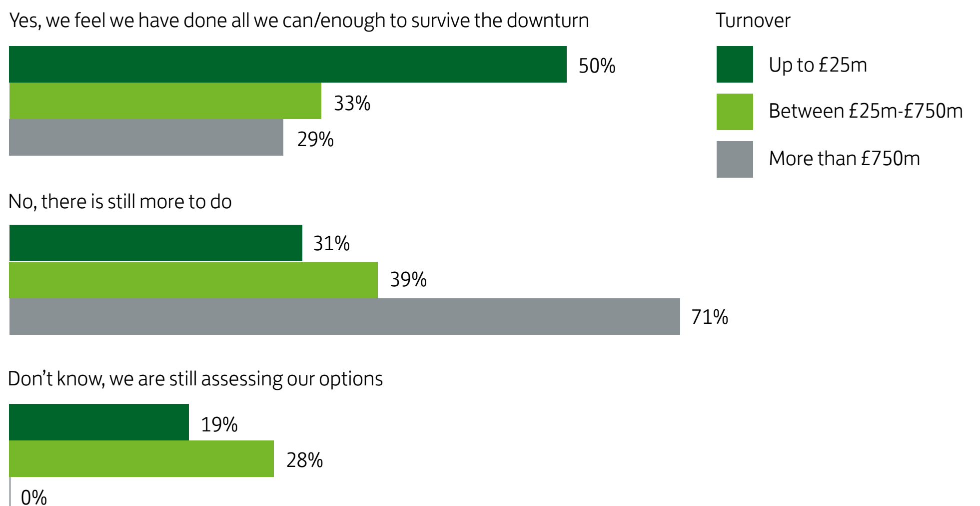
But this downturn has been quite exceptional and has clearly caused major rethinks. Assuming that the bottom of the trough was reached in January 2016, it has endured for about 550 days, with an apparent price rally to $60 in April-June 2015 turning out to be a false dawn. The depth of the price fall has also come close to matching that of the 2008 slump. But now, expectations of a significant upturn have all but disappeared and "lower for longer" has become a stock industry phrase. Asked when they expected Brent crude to recover to $75-80, only one company thought it could happen this year, a third of respondents (33%) expected 2018, but nearly four out of ten (38%) thought it would come in 2020 or later, with large companies especially conservative – six out of ten (58%) reckoned on 2020 or later.

The length and severity of the slump has caused the continual re-evaluation of strategies. For example, while companies in last year's survey were slightly more cautious in their price predictions (forecasting on average $55 for January 2016), the rapid slide beneath this level in the second half of 2015 clearly caused firms to look again at their expectations. Only 45 per cent of firms surveyed this year engaged in some expansion – by diversification, organic growth, or merger/acquisition – half the number that expected to expand at the start of 2015.

The need for further adjustment and the continuing uncertainty is inevitably reflected in year-ahead intentions being a lot more cautious than they were twelve months ago. Just under half of companies (48%) expect to reduce operating costs and intend to take efficiency measures. But 30 per cent hope to grow their business by diversifying, 14 per cent intend to grow organically, and five per cent aim to grow mostly through mergers and acquisitions. It adds up to those aiming for growth just outnumbering the non-growers.

[1] Boston Consulting Group, 'Lower and more volatile oil prices: what they mean and how to respond', by Iván Martén and Philip Whittaker. BCG Perspectives, January 2015

If you have been severely or badly impacted, are you confident that your business has done enough to survive the downturn?



50%

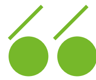
of drilling companies are contemplating scale backs or efficiencies

29%

of construction companies are concentrating more on growth by diversification

The intentions of major firms are far less positive. Nearly three-quarters of them (72%) are concentrating on efficiency measures or cost-cutting and only a quarter (25%) on some growth.

There is also regional variation to consider. The proportion of firms aiming either to scale back operating costs or to implement efficiencies is at its highest in Scotland (55%) and lowest in East Anglia (38%), this part of England being much more focused on gas which is less affected by price falls. The sectoral variation is even wider – 50 per cent of drilling companies are contemplating scale-backs or efficiencies, as are 55 per cent of marine service suppliers and 62 per cent of exploration and production firms. But only 34 per cent of equipment suppliers are thinking in this direction, as are 35 per cent of construction firms within the oil and gas industry. These two sectors are concentrating more on growth by diversification – named as a goal by 50 per cent of equipment suppliers, and 29 per cent of construction companies. Some 21 per cent of the construction sector also aim to grow organically.

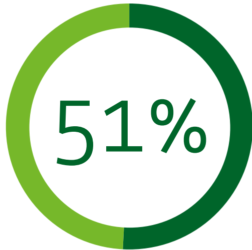


The length and severity of the slump has caused the continual re-evaluation of strategies.

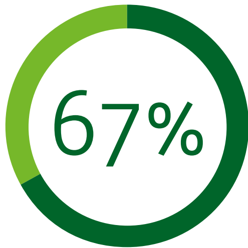
Asked how these plans would affect their activity in the UK, 44 per cent of the 70 companies in the sample expressing intentions to pursue growth estimated that any expansion would be modest, at less than 10 per cent of present turnover, but almost half (43%) were more ambitious, aiming to achieve 11-30 per cent growth. Of the 26 firms planning to scale back operating costs, two were large firms planning cuts of about 25 per cent, while 17 of the others were small firms that estimated, on average, about 21 per cent of their UK costs would be cut.

Optimistic
30%
Neutral
42%
Which of the following best describes your current business confidence for the next 12 months?
28%
Pessimistic

EMPLOYMENT



of all companies have had to cut jobs



of major companies have had to shed employees

For jobs dependent on the North Sea, 2015 was very challenging. This survey indicates that the bad news on jobs will continue in 2016, but it is expected to be at a much lower level, at about a third of the cuts made last year. Job losses so far have clearly run into five figures, but quite how far this will go is difficult to know with any certainty.

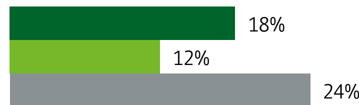
Cuts have been announced by producers, by contractors who work alongside producers' workforces, and by suppliers of specialised skills and equipment, but many of these announcements also include positions that are based overseas. There have also been unannounced losses – jobs which have gone in low single digits from smaller companies, self-employed workers whose contracts have dried up, or by the non-replacement of retirees. Surveys such as this one do not pick up some of this detail, so for these reasons, this report has not sought to quantify the UK employment contraction across the industry.

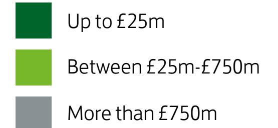
In this year's survey, half of all companies have had to cut jobs (51%), a third have managed to keep their workforces stable (29%) and a fifth have managed to increase staff numbers (20%). It is worth recalling that despite the downturn, eight new oilfield developments were completed last year at a total capital cost of £11.6 billion and a further eight are continuing development in 2016[2].

[2] Oil & Gas UK, Activity Survey 2015, February 2016

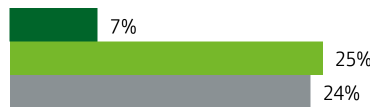
In terms of your business' head count, what are your intentions over the next 12 months?

Headcount will decrease, we will cut jobs/make redundancies



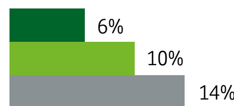


There will be a net reduction

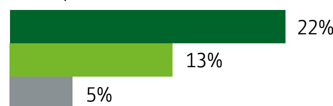


Our headcount will remain the same

There will be a net increase



We hope headcount will increase through recruitment



The major companies have been worst hit – two-thirds have had to shed employees (67%). Firms that have been net recruiters have been mainly small or medium-sized. The worst hit sectors have been drilling (83% of companies recording jobs lost), marine services (66% have made net or absolute reductions) and, rather worryingly, inspection, repair and maintenance companies (70% recording job loss).

This pattern conforms to what has been described as "predictable, tactical efforts to reduce costs" by oil producers, concentrating on reducing capital spending, staff and contractor numbers, and workforce and contractors' pay, rather than making strategic changes. Cuts in oilfield service companies' fees, reckoned to have been 10-30 per cent, led to significant lay-offs because they are major employers[3].

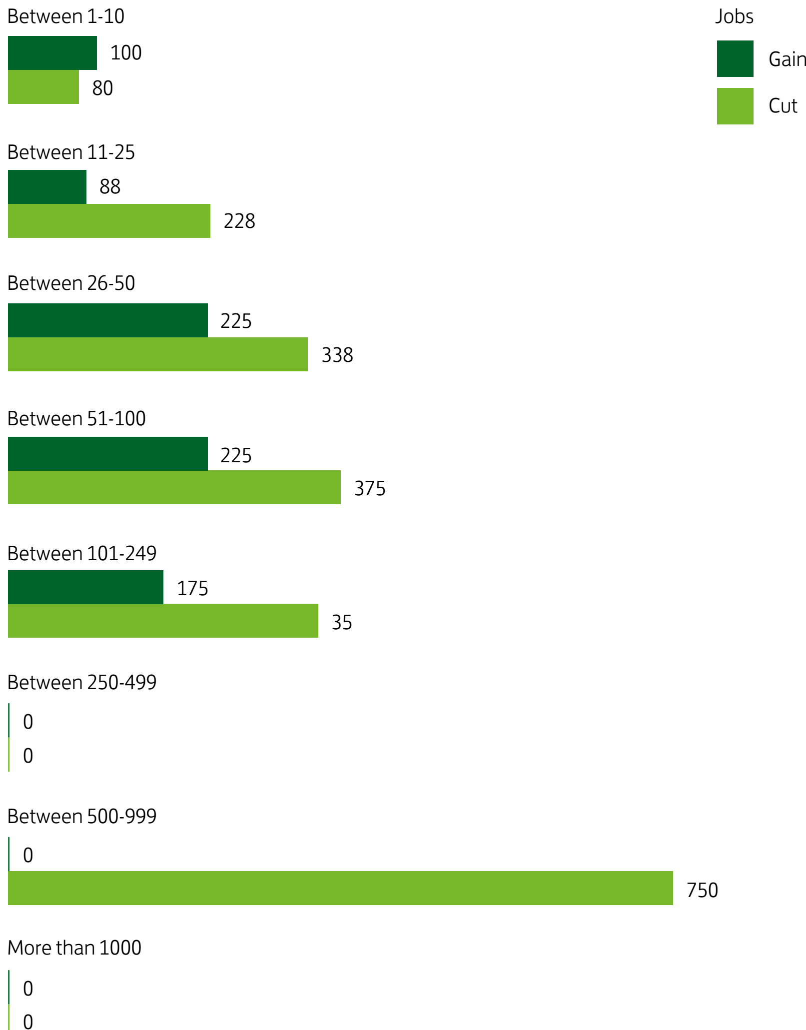
The survey indicates that for every job lost in exploration and production, eight were lost in the services and equipment supply chain.

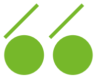
[3] PwC, Opportunities in adversity, Strategies for a lower oil price, October 2015

41%

of those surveyed thought that young people would not see the sector as a viable career option

If you are looking to increase/net increase and decrease/net decrease, by how many over the next 12 months?





This trend is a big concern and will automatically mean that there is a gap in the supply of talent coming into the industry.

However, there are signs that if price rises in March 2016 to above $40/barrel can be sustained, the worst may be over – though there still will not be an immediate end to the bad news. In 2015, the bulk of the job losses occurred in major layoffs of more than 250 people by significant employers. The losses were offset to a modest extent by gains at a ratio of one job gained for every six lost. For 2016, the big number losses are expected to be fewer, as are the smaller losses.

Executives' responses indicate the total cuts across the North Sea and the onshore supply chain may still number in the thousands.

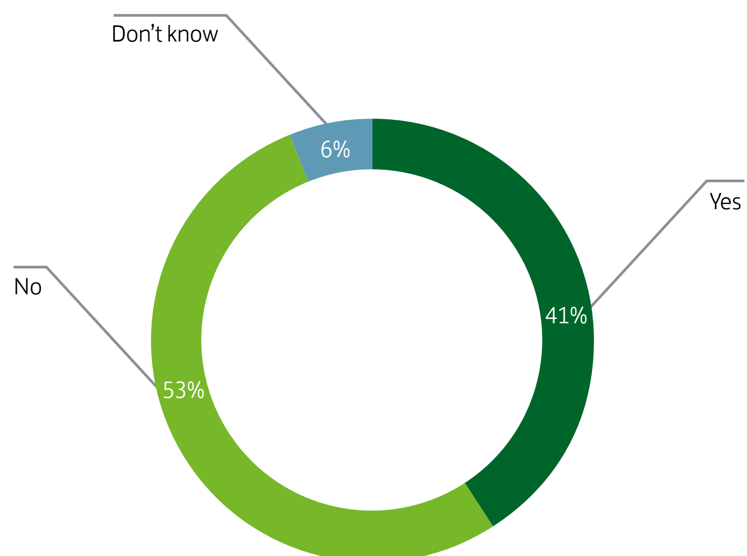
Equally, the net job gains expected are a little bigger, at a ratio of one job created for every three cut. Overall, it is not great news, but does signal hope that employment trends may be bottoming out.

About two-fifths of the companies expecting further cuts are based in Scotland, though the numbers involved are relatively small at about 20 jobs per company on average. A sixth of the others facing cuts are in London, and their forecasts are heavier at more than 100 posts per company on average. Drilling firms and logistics providers indicate they may take the heaviest hits.

A longer-term concern, which may not disappear with a price upturn, is ongoing negative employment data further hampering the perennial problem of attracting skills into the industry. Two-fifths (41%) of those surveyed thought that young people would not see the sector as a viable career option, creating a skills gap that is further exacerbated by the cyclical nature of the industry. Attrition was particularly high during the 1990s, when oil prices bounced around at $20/barrel. During the 2008 global recession, a number of organisations cut back or stopped their graduate programmes for a couple of years. This trend is a big concern and will automatically mean that there is a gap in the supply of talented men and women coming into the industry.

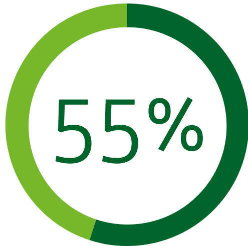
Slightly more than half (53%), however, believed either that young people would see the downturn as part of the natural lifecycle of any industry and would still recognise its long-term prospects, or that any concerns caused by the downturn would dissipate once the industry was on an upwards trajectory.

Are you concerned that the current downturn in the sector will impact on talent/skills coming into the industry?



34
32
30
24

OPPORTUNITIES



believe that there were new opportunities despite the current business climate

If the industry has experienced a severe employment downside, there are still opportunities which do present some potential upside. This may sound counter-intuitive given that the sector as a whole is retrenching – reducing capital spending and workforces, but companies have developed strategies to move forward. Some are building on strengths. For example, Total, Europe's third-largest company in deepwater production and liquefied natural gas (LNG), aims to raise $15 billion through asset sales between 2015 and 2017 to spend on projects such as the Laggan/Tormore gas fields west of Shetland, which came on stream in February 2016.

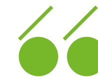
Although it cost £3.5 billion ($5 billion) to develop, its use of subsea installations instead of platforms keeps operational costs low, with only 80 onshore jobs maintaining the flow of eight per cent of UK gas needs[4]. Total Chief Executive Patrick Pouyanne has also said: "The opportunities will really come if oil prices remain low over a longer period. Then you will see real opportunities for major companies like Total."[5]

At the same time, there are still opportunities at the other end of the business size scale, particularly for small companies which have developed specialist skills and technologies that cut costs and improve efficiency – plus there are bigger companies and investors keen to find such opportunities[6].

[4] EnergyVoice, Exclusive interview: Total boss says Laggan/Tormore first gas proves 'there's a future for the UK offshore industry', February 2016

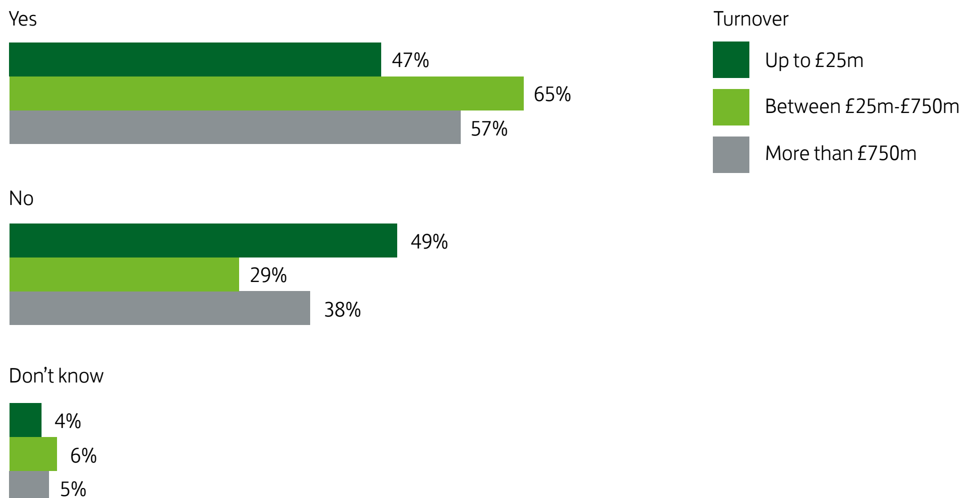
[5] Bloomberg Business, Total Sees Deep Offshore, LNG Acquisition Potential as Oil Falls, April 2015

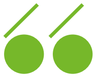
[6] Oil & Gas UK, Game-changing technology outlined to capacity crowd at Technology Showcase, press release, March 2016



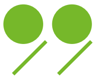
There are still opportunities which do present the industry with some potential upside.

Has the current business climate presented new opportunities for your business in the UK?





Company size influences how executives see the main opportunity priorities.

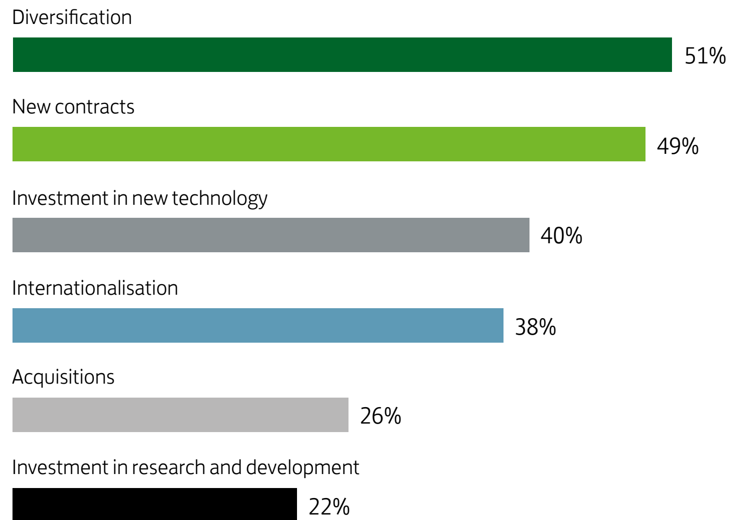


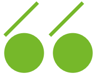
This helps to explain why this survey found that more than half of all companies surveyed (55%) believed that there were new opportunities despite the current business climate, with interest in such openings especially keen amongst mid-sized companies.

Amongst all businesses, diversification tops the list of potential new opportunities (51%), with new contracts a close second (49%). New technology (40%) and internationalisation (38%) are also of interest to a significant number of companies.

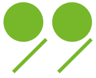
Relatively low interest in investing in research and development (22%) probably reflects company intentions to make more use of innovations by other firms rather than do their own innovating. Company size influences how executives see the main opportunity priorities. Small companies are the most focused on diversifying and finding new contracts, areas that are given equal priority, along with internationalisation by large firms. Investment in new technology is given the most priority by mid-sized firms (50%).

What new opportunities have been presented?





At least £17 billion is forecast to be spent on cleaning up redundant infrastructure over the next decade.



Interest in areas of diversification is, however, shifting. This is probably due to the oil price fall affecting the profitability of unconventional oil production, expansion of which has slowed in North America. Interest in onshore shale gas has dropped from last year with just under a third of all companies (31%) giving it a high priority compared to just under a half last year.

Although big company interest has also dropped since 2015, 52 per cent still have a high interest in shale.

Small firms have maintained their interest in renewables work, but the eagerness of mid-sized and large firms to get involved has dropped, perhaps because of continuing uncertainty over government support for the sector. Interest in working with utilities is at roughly the same level as that for renewables work, with mid-sized companies the most interested.

One possible area of work has grown from the discussions oil and gas companies have had with the nuclear industry; both sectors seeking to learn lessons from each other in decommissioning closed plants and facilities[7].

Decommissioning is most keenly seen as a major opportunity by big companies (57%), which is unsurprising as at least £17 billion is forecast to be spent on cleaning up redundant infrastructure over the next decade[8]. Some estimates reckon that, because of the oil price fall accelerating oilfield closures, the sum spent will be much larger[9]. The work is attractive, particularly to larger companies, as the experience gained in the North Sea will be highly exportable.

[7] Oil & Gas UK, Co-operative Approach Results in New Guidance for Industry's Decommissioning Innovators, November 2015
[8] Oil & Gas UK, Decommissioning Insight Report 2015
[9] BBC News, North Sea could lose 150 platforms in ten years, February 2016

Are you interested in diversifying into work involving utilities?
% of companies showing high interest (8-10 on a scale of 1-10) in 2016

Up to £25m turnover

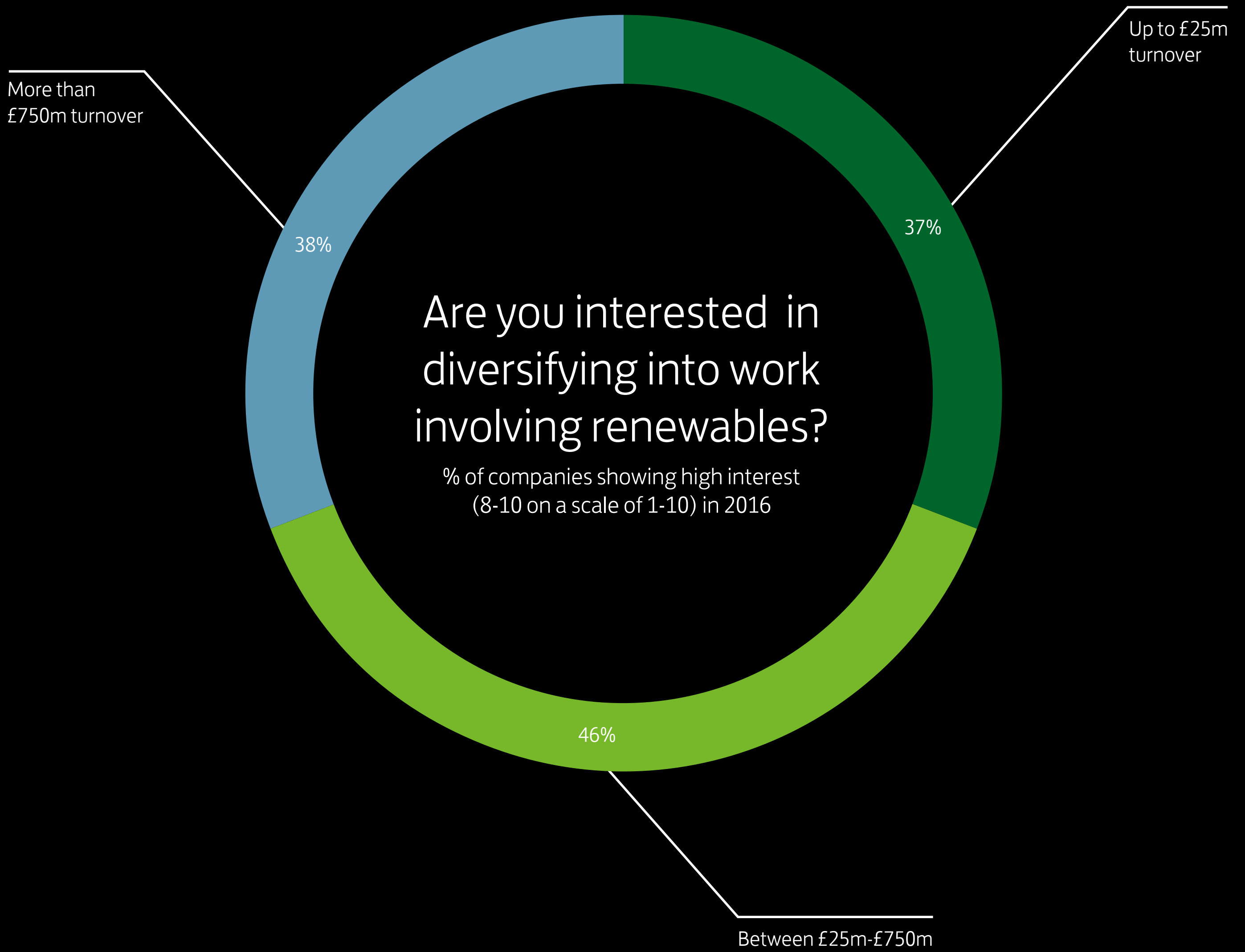
22%

Between £25m - £750m turnover

37%

More than £750m turnover

24%


Are you interested in diversifying into work involving renewables?
% of companies showing high interest (8-10 on a scale of 1-10) in 2016
Up to £25m turnover
37%
More than £750m turnover
38%
Between £25m-£750m
46%

EXPANSION – HOME AND AWAY

0%

of large companies in this year's survey sample have any expansion plans in the North Sea

17%

of drilling companies seek North Sea expansion

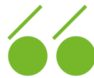
Inevitably, expansion plans in the North Sea have been scaled back. No large companies in this year's survey sample plan any growth in this geographical area (nor, indeed, did any in 2015 despite there being intentions to do so at the start of the year).

But for small companies, there is a slight increase in expansion intentions in 2016 over 2015 and mid-sized companies aim to do the same amount as last year. Among different sectors, about a fifth of drilling companies (17%), and also marine service firms (22%), seek North Sea expansion.

Unsurprisingly, given that the oil price fall is global, there has also been a cutback in international expansion intentions. Interest in North America, traditionally the favourite area for UK firms, has dropped considerably, reflecting the slowdown in unconventional exploitation in both the US and Canada.

The Middle East is also attracting less interest, perhaps because of political and economic uncertainties caused by the price fall. This, however, is not a uniform pattern internationally. West Africa is fast becoming a hotspot for UK firms, underlined by a visit made to Aberdeen in March 2016 by John Mahama, president of Ghana, to open a Ghana-Scotland business forum[10]. Interest in the region is markedly up among small and mid-sized firms, and steady among large companies.

North Africa is also drawing more attention. While Libya remains torn apart by civil war, Egypt has become a lot more enticing with the government working hard to attract foreign investment to develop recent and significant gas discoveries in the Mediterranean, Nile Delta, and the Western Desert. Interest in East Africa is also up, where good-sized discoveries of oil and gas have been made in Uganda, Tanzania, Kenya, and Mozambique and development is underway.

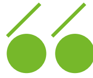


Given that the oil price fall is global, there has also been a cutback in international expansion intentions.

[10] Scottish Energy News, President of Ghana and Deputy Commissioner of Canada visit Aberdeen to promote overseas Scots oil and gas exploration opportunities, March 2016

The Gulf of Mexico and South America, despite the latter's political and economic uncertainty related to state control of the oil and gas industry, particularly in Brazil and Venezuela, are also drawing more interest.

Ultimately, the location of the work is not likely to be primarily driven by oil and gas industry intentions, but by investors and their willingness to commit capital which, as ever, depends on perceptions of where the best and most secure returns are likely to be made.



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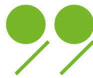
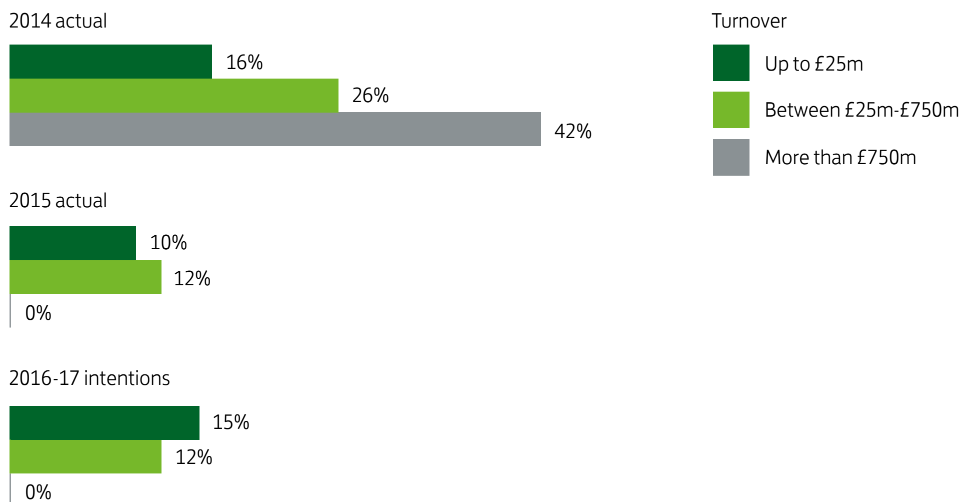


Has your business expanded in the North Sea in 2014 and over the past 12 months? And what are you expansion plans in the North Sea over next 12-24 months?



CHALLENGES

16%

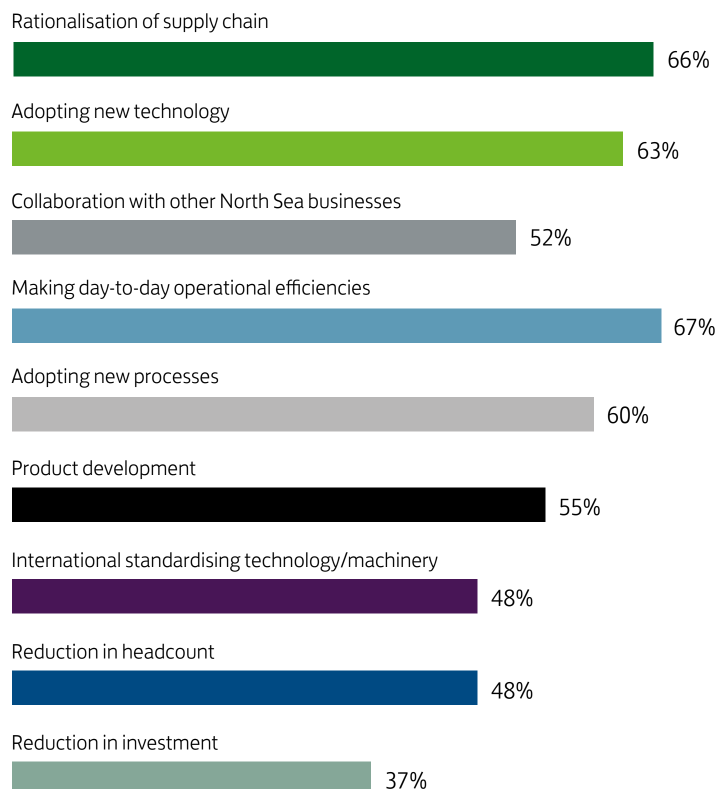
said exploration and development activity would remain permanently subdued

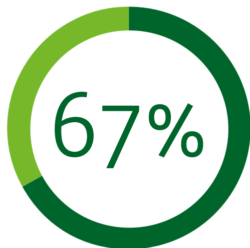
Recent reports have underlined the serious situation faced by the UK's offshore oil and gas industry: "Despite significant cost reductions, nearly half of the United Kingdom Continental Shelf (UKCS) oil fields are likely to be operating at a loss in 2016 at prevailing prices. While this represents about a sixth of total oil production, these fields collectively provide a significant proportion of the infrastructure used to transport oil and gas ashore. Were a number of these fields to cease production, their interconnectivity would mean many more could become sub-commercial, known as the 'domino effect'," Oil and Gas UK's 2016 Activity Report said in February[11].

This year's survey asked executives to choose between statements expressing five views on what would do most to contribute to the economic sustainability of the UKCS over the next two years. A third (33%) said that it was all down to crude oil prices and activity would remain subdued until prices recovered, while 16 per cent said exploration and development activity would remain permanently subdued. A fifth (19%) said that continuing investment was needed to maintain operations and infrastructure, and 16 per cent took the view that investment will focus on late life assets and decommissioning. Just 15 per cent stated the solution was in the industry's hands – that reducing costs and improving efficiency will help stimulate activity. The lack of unanimity emphasised the formidable task ahead and underlying doubts in the industry.

[11] Oil & Gas UK, Economic Activity Report 2016, February 2016

How are you looking to meet the cost challenges in the North Sea over the next 12 months?





consider their top tool for reducing costs to be day-to-day operational efficiencies

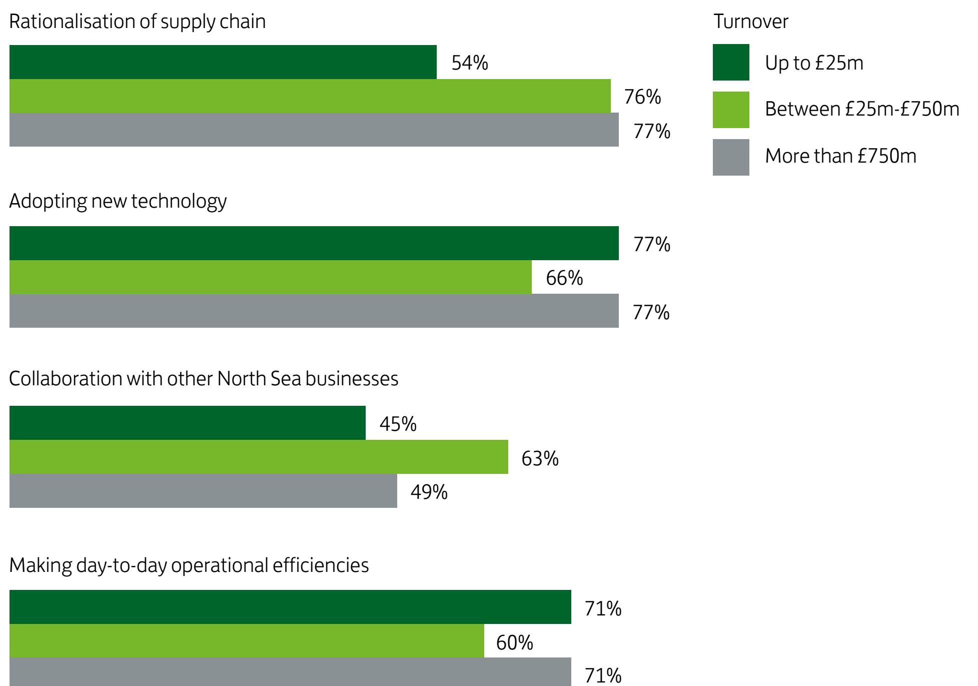
Nevertheless, executives are striving hard to make things work. A more positive tone emerging from this section of the survey is that cutting more jobs is given a relatively low priority, and indeed that the importance of maintaining a skilled workforce is also stressed.

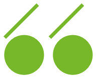
The top tools for reducing costs were considered to be day-to-day operational efficiencies (67%) and rationalisation of the supply chain (66%). Slightly further behind came adopting new technology (given by 63%), and adopting new processes (60%).

Two strategies being heavily promoted by the Oil and Gas Authority – collaboration with other North Sea companies and standardisation of technology and machinery – were backed by 52 per cent and 48 per cent respectively.

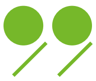
Reduction in headcount still has a role to play, according to 48 per cent, as does reducing investment (37%). Company size makes a difference in strategy – small firms gave a high priority to day-to-day efficiencies (71%), while mid-sized and large companies were more interested in rationalising the supply chain (77% of mid-sized businesses, 76% of large).

How are you looking to meet the cost challenges in the North Sea over the next 12 months?





The heavy cash flows of 2009-14, which benefitted not just producers but also spread down the supply chain, have shrunk.

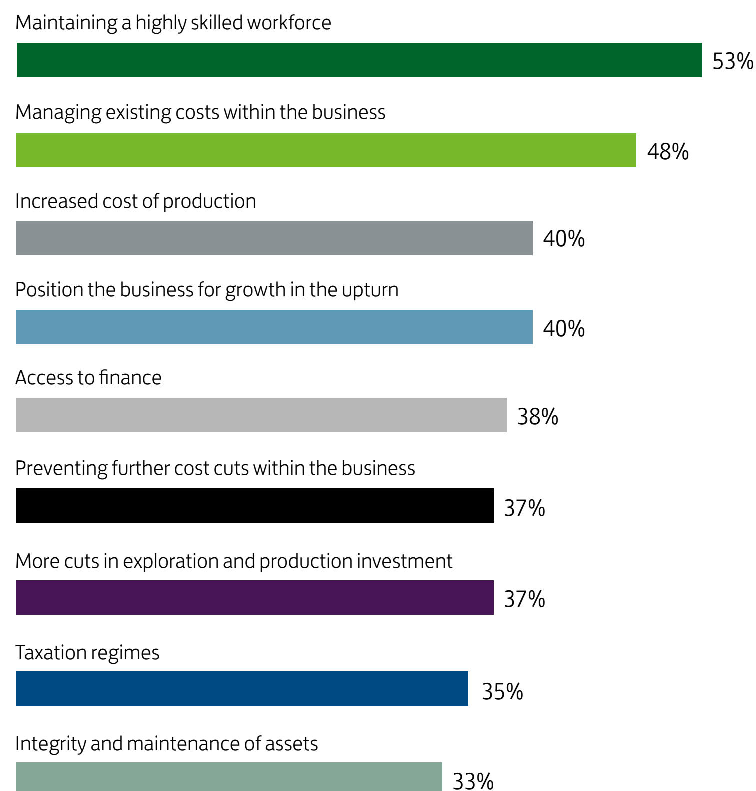


The extremely difficult balancing act faced by executives is emphasised by the fact that, while cutting jobs may be necessary, maintaining a highly-skilled workforce was said by 53 per cent to be the biggest challenge over the next two years, just ahead of managing costs (48%). And the multi-faceted nature of the task also emerges in the finding that seven other challenges were listed by more than a third as among the biggest challenges – increased cost of production, positioning for growth in the upturn, access to finance, preventing further cost cuts, more cuts to exploration and production investment, taxation regimes, and the integrity and maintenance of assets.

The price downturn has also thrown up what may be a new challenge for many companies after the five years of $100+/barrel – financial risks. The heavy cash flows of 2009-14, which benefitted not just producers but also spread down the supply chain, have shrunk. The industry is moving from being cash-rich to cash-poor and, in investors' perceptions, from being mid-risk, high-return to high-risk, low-return, in very short order. The sector has been, to some extent, financially cushioned by hedging, fixed-price contracts, and cash reserves.

These cannot last forever and if the oil price fails to rise or, worse, falls further still, identified by more than two-thirds of firms (66%) as the top financial risk, then some companies will become dangerously exposed. A second tier of risks potentially stems from failing to manage costs or production targets or, conversely, not having the right skills in the workforce to meet targets. Executives, cognisant of these risks, also recognised that they could cause future liquidity problems (identified by 45%), bank covenant breaches (40%) and forced asset sales (38%).

What do you consider to be the biggest cost challenges in the North Sea over the next 12-24 months?



66%

of businesses identified a further oil price fall as the top financial risk

53%

believe maintaining a highly skilled workforce to be the biggest challenge

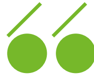
FINANCE

of large companies have been most inclined towards asset based lending

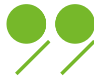
Heavy use of cash reserves by companies of all sizes dominates the forms of finance used by businesses in the last year – not surprising and, so far at least, readily available for many firms. As these run down, companies will have to become more innovative in their financing options. There is evidence from the survey that they are already quite well along that track.

Mid-sized companies have found resources in partnerships (used by 23%) and trade finance (21%). Large companies have been most inclined towards asset based lending (24%), joint ventures (19%) and Enterprise Finance Guarantees (19%). There is a bigger spread of financing tools amongst small firms including the use of private equity (16%) and resort to more traditional overdraft finance (18%). All forms have been used to a greater or lesser extent by all companies.

This clearly implies that funders/providers of capital will have a bigger role to play in assisting the wider industry moving forward. The industry's expectation of this is clearly signalled in responses to a question on what



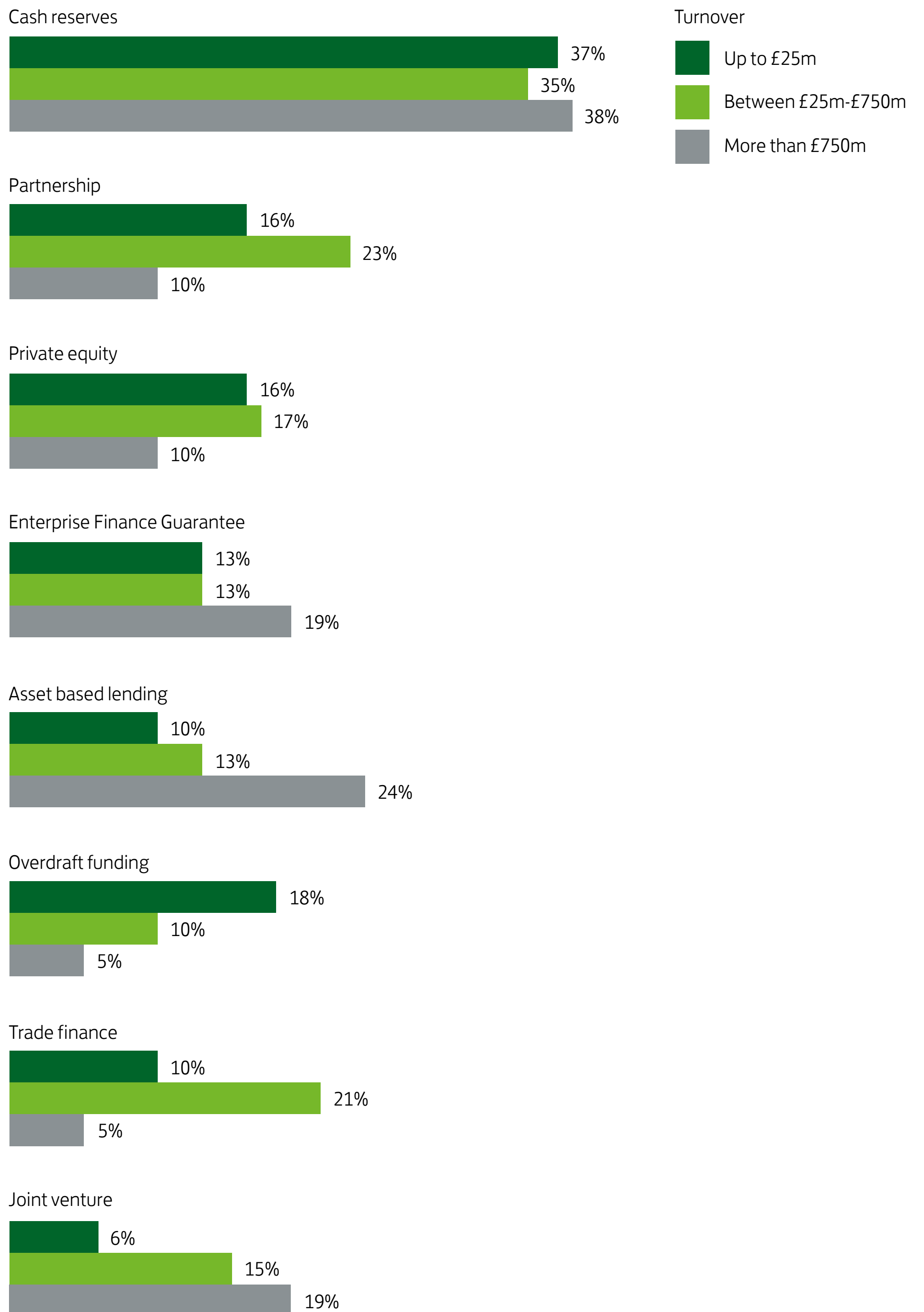
Companies will have to become more innovative in their financing options. There is evidence from the survey that they are already quite well along that track.



support the UKCS companies will need over the next year. No less than 71 per cent of large firms said they needed greater financial support.

Debt worries evidently weigh more heavily on them than smaller companies as 57 per cent of large companies said they needed greater support from banks to manage debt. They are also more likely to want corporate finance expertise to manage merger and acquisition activity – identified by 43 per cent – than smaller companies. But the high level of responses to all the forms of financial support (about a third of all companies said they wanted advice on cash flow finance options from banks) indicate that there is a growing need across the sector for help with improving financial management.

What new forms of finance have you used in the past 12 months to support the business?



Around half of all companies wanted to see a basin-wide fiscal stimulus to encourage exploration and preserve the stimulus to late-life fields. UK Chancellor George Osborne did deliver a tax cut of 40 per cent on all fields in his March 2016 budget and another £20 million for a second round of seismic exploration in 2016-17 to be made available to all exploration companies. But the industry's reaction was very mixed and it remains to be seen whether it does the job Mr Osborne expects[12].

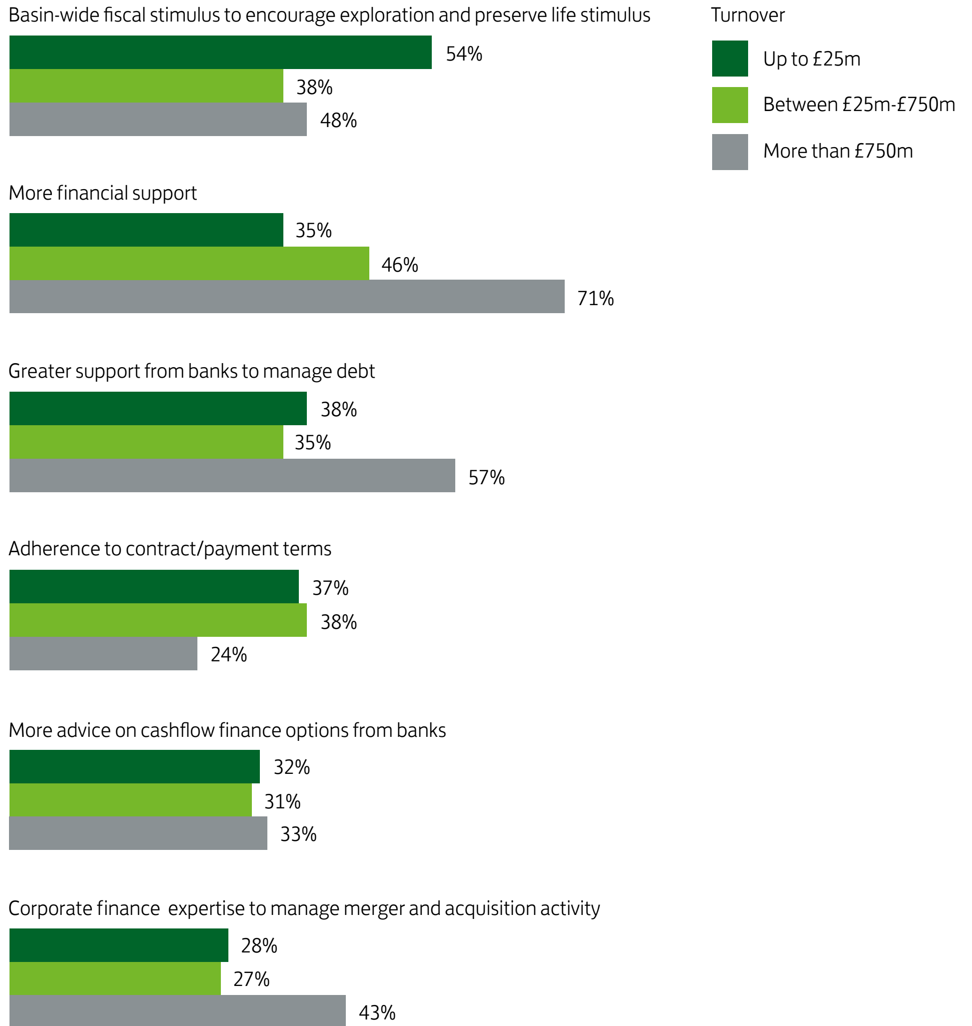
One factor on the industry's side in financing issues is low current interest rates. But it is an open question how long rates will stay low, so it may be prudent for companies to deal with finance problems now rather than put them off.

[12] The Press and Journal, Chancellor gives struggling North Sea £1bn boost, March 17

57%

of larger firms need greater support managing debt

What support do you think the industry operating in the UKCS will need over the next 12 months?



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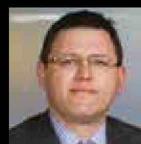

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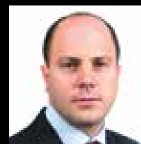

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- *Oil & Gas UK, Economic Activity Report 2016, February 2016.*
- *The Press and Journal, Chancellor gives struggling North Sea £1bn boost, March 17.*

Information is correct at time of printing: May 2016.

Methodology

Field research for this report was undertaken in December 2015, January and February 2016 by Coleman Parkes Research. To gather representative data, a cross-section of 141 oil and gas businesses were interviewed. Companies ranged in size, from less than £25m, to between £25m and £750m, and more than £750m annual turnover.

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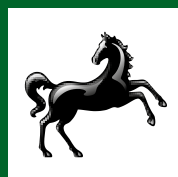

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