Upstream on the up?

A sign of changing times

Recent times have seen a trend of rising oil prices and some are beginning to see signs of a fragile stability in the upstream oil and gas sector. Those of a more optimistic persuasion are identifying indications of predictability and a basis for investment in long-stalled prospects and a resumption of normal service in relation to day-to-day corporate activity.

Processes of business adjustment and cost management are seen to have re-modelled a number of businesses to be appropriate for an environment of lower, or less volatile, petroleum prices. Those upstream companies which have been in thrall to their lenders or bond-holders are largely seen to have re-structured their business and themselves so as to placate these foes for now, if not yet escape them for good. Some companies have sadly succumbed to the hostile business environment of recent years. And as a degree of confidence has returned to the sector, will the buoyancy of higher prices see the traditional participants return to their old ways, or have things changed for good?

Competition for investment

Although not often seen as a market, there is growing competition among host states for the investment budgets of upstream oil and gas companies. Signature bonuses and other financial commitments in relation to Brazil suggest that predictable geology may merit a premium even where stability and predictability of operations and contractual terms have not been prevalent. For those states which may have to work harder to attract investment, there are growing indications of responsive commercial terms and transparency. If there is a change of mood then this may also have been influenced by a gathering suspicion that the traditional debate over peak oil is moribund and that there is now a real prospect that not all reserves of petroleum will, in fact, come to be produced. The treatment of costs and their recovery and the measuring of profits or returns remain troublesome. However, there are indications of the mood moving towards relationship-building and trust (on both sides) as preferable models to the traditional reliance on the obsolescing bargain as a counter to the expected manipulation of the prevailing regulatory and fiscal arrangements by foreign investors. Some would go further still and suggest that the traditional, dogged reliance on the written word and the rule of law (as set out in obligations of local content, local participation, domestic supply and the like) must accommodate a greater role for the context and changing circumstances of these necessarily long-term relationships.

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Mexico's example

The reforms of its petroleum sector made by the state of Mexico in recent years are seen by some as an example of a more business-like approach to the attraction of foreign investment and an apparent recognition that there is competition for the budgets of oil and gas companies. Transparency, flexibility of fiscal arrangements and steps of confidence-building are seen to have encouraged investors to participate in the post-Pemex-monopoly developments. This year has seen a change in government and indications are of a cautious and determined approach to further investment in the oil and gas sector. The reforms were implemented in quick time and effected new and amended laws and constitutional changes. The implementation of these arrangements was made in managed stages and with apparent understanding and responsiveness in relation to investor comments and preferences.

One of the early production sharing contracts following Mexico's reform of its petroleum sector was made in 2015 and related to offshore Block 7. The grant was to a joint venture of Talos Energy (as operator), Sierra Oil and Gas, and Premier Oil. The field's first well (which was also the first offshore exploration well drilled by the private sector in Mexico) made a world class oil discovery. Both Talos Energy and Sierra Oil and Gas are independent oil and gas companies which are partially owned by leading oil and gas private equity business, Riverstone Holdings. A sign of changing times.

Fiscal opportunism?

Looking more broadly, and particularly towards Africa, an area of tension between host states and foreign investors has been the sale of production sharing interests at around the time of declaration of commerciality and before the move to development and production. There have been several examples where a sale of the interest at this stage has been seen by the state as akin to profiteering by the foreign investor. The foreign investor is perceived to be making a capital gain from its exploration and appraisal works and without going on to create the production revenues in which the host state has expected to share. One response has been the introduction of taxes on gains,

By Michael Polkinghorne, Philip Stopford and Jason Webber, White & Case LLP

usually where these have not previously existed and often despite the terms of the relevant grant. Whether these sales of petroleum interests by foreign investors are a matter of tactical commercial opportunism or the result of a determined business strategy, one of the consequences of these state actions is likely to be a greater state revenue from a single production sharing interest than would have been the case in the absence of a sale at that stage and the (expected) development by the recipient of the relevant grant.

An energy model?

The market conditions of recent years and the gathering pace of the energy transition away from petroleum in many areas have also caused international oil and gas companies to review their businesses. If there is to be a lower-carbon future, then how will the established order adapt to that and how great a part will oil and gas play as the bridge towards a lower-carbon future, and their own extinction?

Matters of reserve replenishment continue to vex. Natural gas is seen as coming to constitute a greater part of petroleum demand and the uncertain pace of progress towards non-fossil fuels makes projections and forecasts difficult in relation to petroleum reserves. And the growth of supply of shale gas and tight oil (particularly in the United States) casts doubt over the planning of conventional reserves. The traditional assessment of drilling for reserves or buying them is beginning to appear too simple an approach in a more complex world. With discovered volumes at reduced levels and conventional fields continuing to decline, what are the preferred strategies towards assessing and then acquiring petroleum reserves? For some, shale gas and tight oil in the US have become the flexibility in the market with increases of production being encouraged by market prices, and then having the effect of moderating them.

Is the reality, in fact, not "lower-for-longer"?

> The oil and gas business has not wasted a good crisis

The early indications are that the oil and gas business has not wasted a good crisis. Operating and administrative costs have reduced considerably and the downward trend continues for now. But if the reality is, in fact, not "lower for longer", then will the current culture of cost management slip quietly to become some cost reduction projects and then simply a memory?

Oil and gas companies will require resilience and different business structures in the circumstances of a transition towards a lower-carbon economy. And if the industry is to be subjected to the scale of disruption suffered by some other sectors, then that resilience will need to be all the greater. Most oil and gas companies seem now to see themselves as committed to producing their core products at the lowest cost and with the lowest carbon contribution, and to pursuing new businesses beyond their existing primary areas of concentration. Some though go further and see themselves as moving towards being energy companies, with a portfolio of hydrocarbons, wind, solar, hydrogen, carbon capture and more.

But some seem unwilling to see hydrocarbon companies make their way along this new route without paying for the consequences of those hydrocarbon businesses. The growth of climate change litigation over recent years (particularly in the US) has yet to find favour in the courts. However, this seems not to have deterred would-be claimants. As well as seeing a reduced appetite for hydrocarbons among the portfolios of investors in the future, there

are also few signs of the abatement of the cause of those who seek compensation for what they see as the consequences of the development of hydrocarbons in the past.

An energy transition

With growing energy demand and demands for the reduction of the emissions that contribute to climate change, many companies are alive to the resulting inconsistencies and are seeking ways to reconcile these. Whereas solar and wind will play a central role in a transition towards a lower carbon future, they will only be part of that transition. The simple scale and diversity of the petroleum sector and its span from generation to transport to petrochemicals and beyond suggests that it will remain a leading participant in the world's economy for many years to come.

For some, it is natural gas that has the greatest role to play among these hydrocarbons in moves towards a lower-carbon future. It is abundant and is the cleanest-burning fossil fuel with economic and environmental benefits and comparative flexibility. It is a reliable partner for renewable sources of energy and is seen as a bridge towards a lower-carbon future. For others this view exhibits a lack of ambition. They see that natural gas is not in transition to its own demise but is a destination in itself, and point to developments in biomethane and hydrogen to show how natural gas is itself a renewable. This view suggests that this is no time for natural gas to be apologetic for itself. Instead, it is time for it to claim its place in a decarbonised future and to see off its present competition, which is coal. In Europe, coal has seen increased usage of late, despite policies to achieve the opposite. And whereas the use of coal tends to play to a domestic agenda, the growth of gas is likely to require greater cooperation and association than has been seen to date, and an ending of inconsistent climate and energy policies, particularly in Europe.

The attraction and development of the best people remains a core aim for all oil and gas businesses

Organisational change

The attraction and development of the best people remains a core aim for all oil and gas businesses. But fulfilling this aim becomes more difficult as other, newer sectors tend to be seen as more appealing to newer generations. The oil and gas business faces changes in how it explains and promotes its work, and how it portrays its image to those newer generations. The recognition of the importance of the development of people has led to a keener concentration on commercial sense, skills of developing and maintaining relationships of long-term trust, and collaborative and integrated working across disciplines and regions. Flexible ways of working are part of the industry's modernisation. Also part of this modernisation are rapid moves towards digitalisation, automation and artificial intelligence. This marrying of people and technologies, or the plumber and the tool box, may be a key to greater growth.

Services and more

Some traditional lines of separation are becoming blurred as those in the oil and gas business adjust to recent events and seek to develop new businesses in new environments. In a cyclical industry, some may be more at risk than others to the lows and at benefit of the highs. This has been the traditional lot of the services sector. But with declining access to the highs and growing exposure to the lows, some have been revising their model. These revisions have included corporate consolidation along

with developments of financing and payments by reference to production. Among the most interesting have been the moves by a number of those in the service sector (Schlumberger, Petrofac) towards upstream interests as part of their businesses. Whereas some see this as a way of winning services contracts, generating cash from production and controlling operations, others see conflicts of interest and irreconcilable distortions of business: the provision of technical capability may be undoubted, but is there, for example, capacity for the funding this model requires?

Liability or opportunity

Towards the other end of the upstream oil and gas cycle (and in the context of licence regimes more than those of production sharing), recent times have seen a number of corporate transactions which have concerned late-life facilities and their decommissioning liabilities. At a time of scant upstream M&A activity, these deals have been notable in any event. But they have attracted particular attention in light of an apparent change of approach to deal doing on the part of a number of larger, incumbent oil and gas companies, and the significant arrival of new entrants from the environment of funds and private equity. These deals also highlight that an end of a production grant and the end of field or facility life are not necessarily coincident.

Those investing private equity or funds into upstream oil and gas have brought new and different analyses and initiatives. For example, Premier's development of its Tolmount field in the UK North Sea has been effected in cooperation with infrastructure owners and developers. Pursuing a concentration on infrastructure and limited risk (and perhaps an aversion to reserve and upstream risk), an affiliate of CATS Management Limited will lead the creation of related infrastructure and facilities, while Premier Oil will pay a tariff over time for use.

Nature of grant/decommissioning

The traditional attitude towards decommissioning and late-life oil and gas facilities has been largely negative, with companies viewing mature installations as a burden to be managed rather than an opportunity for business. But the mood may be changing. Following the reduction of oil prices in recent years, incumbent owners, keen to repair their balance sheets, started to view their ageing assets as an opportunity to pass on these operations to smaller, more nimble players with businesses better suited to carrying out smaller works and enhancing overall recoveries. Potential investors have needed to be comfortable with a regulatory regime which typically assigns liability to parties deriving financial benefit from petroleum assets—whether in the present or in the past. The allocation of decommissioning liabilities has traditionally been a difficult issue in M&A deals, as sellers have sought a 'clean break' from these liabilities. Growing stability is prompting interest among producers, and the supply chain and service sector, where new business models and deal structures work on the opportunity of decommissioning. As part of this change, there has also been a focus on facilitating the use of specific decommissioning security arrangements to create funds sufficient to meet the expected decommissioning liabilities after cessation of production.

And government is supporting commerce. For example, the UK has recently seen the introduction of new fiscal arrangements which enable the purchaser of late-life assets to have the benefit of the seller's accrued allowances and tax history, even in the context of an asset sale.

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Although recent deals in the North Sea suggest a mood of some optimism under the prevailing regulatory regime in relation to late-life assets, that mood rarely applies in the context of the production sharing arrangements in many jurisdictions around the world. Traditionally these grants have been largely self-contained with few if any provisions relating to decommissioning of installations. Indeed some provide for facilities to revert to the state towards the end of field life. And the customary investor-state flashpoint of costs and their identification, allocation and recovery under production sharing arrangements does not become any less flammable in the context of late-life assets and their decommissioning. In this context, matters of decommissioning of late-life facilities under production sharing arrangements are proving more likely to lead the parties towards conflict and dispute resolution than to new transactions.

The coming years

There are those who take the view that the industry has weathered a storm and that this is now business as usual. There are others, and this is the majority, who see a recently-found stability and grounds for optimism: but in a petroleum sector which has been changed for good. And if those who fail to learn from the lessons of the past are condemned to repeat them, then, in today's petroleum sector, those who fail to learn from the lessons of every new day, may not be here at all tomorrow. ■