E&P companies' risk aversion means less activity

ONE REASON OIL and gas companies have seemingly become less active in North America is the oil and gas industry has over consolidated and become risk averse, according to **John P Herrlin, Jr**, First Vice President for **Merrill Lynch**, who spoke at the 2004 IADC Annual Meeting in New Orleans in September.

The reason is the industry's belief in commodity prices being rather steady, he said, and when industries manage for costs rather than managing for risks, it ends up creating larger companies that spend less.

For example, he says, operators generated an 82% completion success rate in 1990, and at the end of 2003 they generated a 95% completion success rate.

"Some might argue that the success rate is a result of technology," Mr Herrlin said, "but I would argue that it is a result of risk aversion."

RISK AVERSION

Mr Herrlin traces risk aversion back to the 1970s when integrated oil companies over-hired based on their presumption that the oil price was going to approach $100 per barrel.

The "average" E&P company was non-existent then or was a limited partnership, he said, due to the times.

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>
> **John P Herrlin**

As oil fell from its rise toward to $100 down to single digits, the integrated companies found themselves with too many people and not much profitability. The natural conclusion was to cut costs.

"The easiest way to cut costs is to cut heads," Mr Herrlin said.

"Every integrated has cut heads, ExxonMobil, ChevronTexaco, ConocoPhillips and BP.

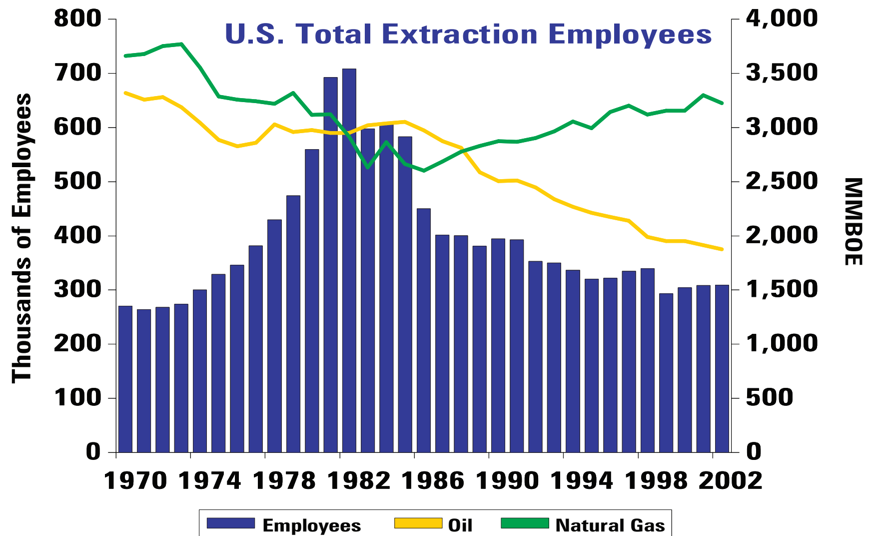
"Do companies, when they merge, spend as much as the predecessor company," he asked. "Absolutely not.

"If you look at business currently, what has happened is we have gone from a risk taking industry to a risk waiting industry."

With the integrated companies, their strategic shifts have clearly been foreign and not domestic.

Many of them, however, have long lead times given the infrastructure needs.

For example, Mr Herrlin said that unless a company pre-purchases equipment such as FPSOs, it's difficult to accelerate development spending in new deepwater provinces.



Merger and acquisition activity has given most purchasers short term production growth with less "execution risk". That doesn't mean that output for the sector has collectively grown as a consequence.

Exploration tends to be event driven and have long lead times since such projects need certain infrastructure. Exploitation moves with commodity price direction, drilling activity or permitting.

Wall Street, in Mr Herrlin's opinion, tends to over-embrace the upside and not consider net present value.

If companies have a rigorous return on capital investment focus and believe in lower normalized commodity price thresholds or the ability to purchase properties for company specific volume growth, they will tend to limit their exploration commitments.

E&P companies are uni-dimensional price takers, Mr Herrlin notes, and generally have a large North American presence. They have to be careful as to the amount they commit to exploration.

In mature basins, it is difficult to reactivate with fewer personnel.

Mr Herrlin stated that the US simply doesn't explore. "Canada drills more conventional wells than the US. We simply don't explore."

While that reflects a mature area, Mr Herrlin also said it reflects risk aversion as well.

"If you look at well completions what you see is that we are drilling more shallow wells and fewer deeper wells. Again, that is risk aversion."

PERSONNEL

There are not a lot of young people in the oil and gas business, Mr Herrlin noted.

"When you look at the employment levels in the US, the average technical worker, the petroleum engineer or geologist, is now pushing 50 years old.

"That is not going to change," Mr Herrlin continued. "If you look at enrollments in most colleges, they are very low."

Mr Herrlin also explained that oil production falls as the head count falls.

"All of the acquisitions that the industry made achieved its purpose," he said.

"Now we need to begin exploring again, but we don't have the people.

"This is going to be more and more of an issue," he emphasized.

FINDING COSTS

Mr Herrlin also blames mergers and acquisitions for increased finding costs for North American E&P companies.

"Acquisition costs have doubled," Mr Herrlin said, "for proven properties, unproven properties, exploration and development.

"That is why I call this industry an acquisition exploitation industry," he added.

He also doesn't see finding costs falling. In fact he predicts that finding costs will continue to increase, as much as 5%-8% in 2004.

OTHER CONSIDERATIONS

One oil industry issue is that of security of supply, Mr Herrlin noted. "No one cared about it until recently," he said.

Whether it is oil or natural gas, sourcing has only recently become an issue.

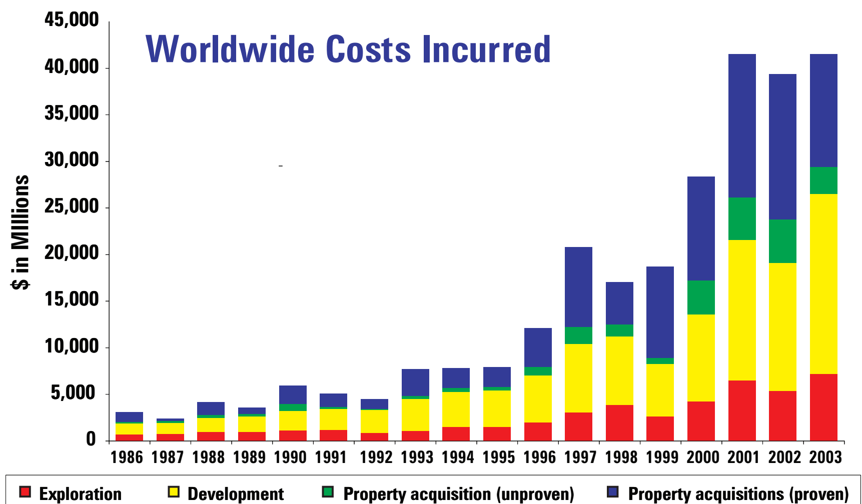
He noted that 60% of oil and 15% of natural gas is imported to the US.

Regarding inventories, Mr Herrlin said that Wall Street appears to have a fixation with API, DOE, IEA and EIA statistics as the harbinger of near-term supply/demand balance.

It has become the new cottage industry, Mr Herrlin contends.

Many of the statistics have a margin of error greater than the minimum required to drive commodity prices up or down, but they move the futures market, which in turn affects cash prices, especially for natural gas and energy stocks.

He also said that hedge funds are attributed for much of the oil or natural gas price run up or volatility. The reality, he noted, is that commodities are an asset class.



The cost of capital is low, stock market returns are mediocre and all commodities, not only oil and gas, have become of interest with low interest rates, he said.

FUTURES MARKET

The cash market takes its cue from the futures market and storage levels. There is more volatility given the demise of the merchants.

Ultimately, Mr Herrlin noted, there may be more natural gas price volatility but fundamentals will prevail because OECD nations and the integrated companies won't bring on supply until 2005 or later.

Additionally, OPEC effectively controls the marginal supply, but it is reaching its limits.

SHORT-TERM OUTLOOK

Mr Herrlin said the industry is seeing a slowing of the asset transference rate between the integrated oil companies and the independents.

He also said there may be more partnering.

The reason, he noted, is that higher impact projects have greater lead times. Also, cash flows are sufficient enough to warrant property retention.

He also noted that foreign projects through the drill bit will be the growth factor of the industry unless North American deepwater gets an Eocene reprieve, the deep shelf or ultradeep shelf activity increases or access issues improve onshore.

LONG TERM

Long term, Mr Herrlin said, the industry needs new technologies for geopressured and hard rock areas, and the people to work in the industry.

These are not new topics, he noted.

The industry has always been about seeing analogous upstream plays and using newer tools to exploit peripheral or remote prospects in a cost effective manner, and to extend the life of existing production infrastructure.

The upstream opportunities are limited. It is more difficult to get good onshore plays cheaply for exploitation or exploration.

That is due to the integrated oil and gas companies retaining properties in light of higher cash flows.

He also noted that there is no fail-safe technology on the near-term horizon to limit resource conversion such as the deep shelf area of the Gulf of Mexico.

Exploration strategies need continual and not erratic capital reinvestment. Also the industry will require more people.

Regarding LNG in the future, he noted that in three years, LNG could prove disruptive but he does not believe LNG will be setting natural gas prices. ■