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Navigating
Turbulence in the
Upstream Oil Sector
*The Impact of
the Global Credit
Crunch and
Plunging Oil Prices*



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EXECUTIVE SUMMARY

Industry analysts, visionaries, fortune tellers—no one predicted the double whammy that’s battering the upstream oil and gas sector. When the price of crude oil peaked at a record high and began to tumble in the wake of unprecedented global credit constraints, oil companies saw billions vanish from their market capitalization. As shock waves continue to roll across the industry, players are not all equally positioned and are responding with different strategies to ride out the turbulence and take advantage of emerging opportunities.

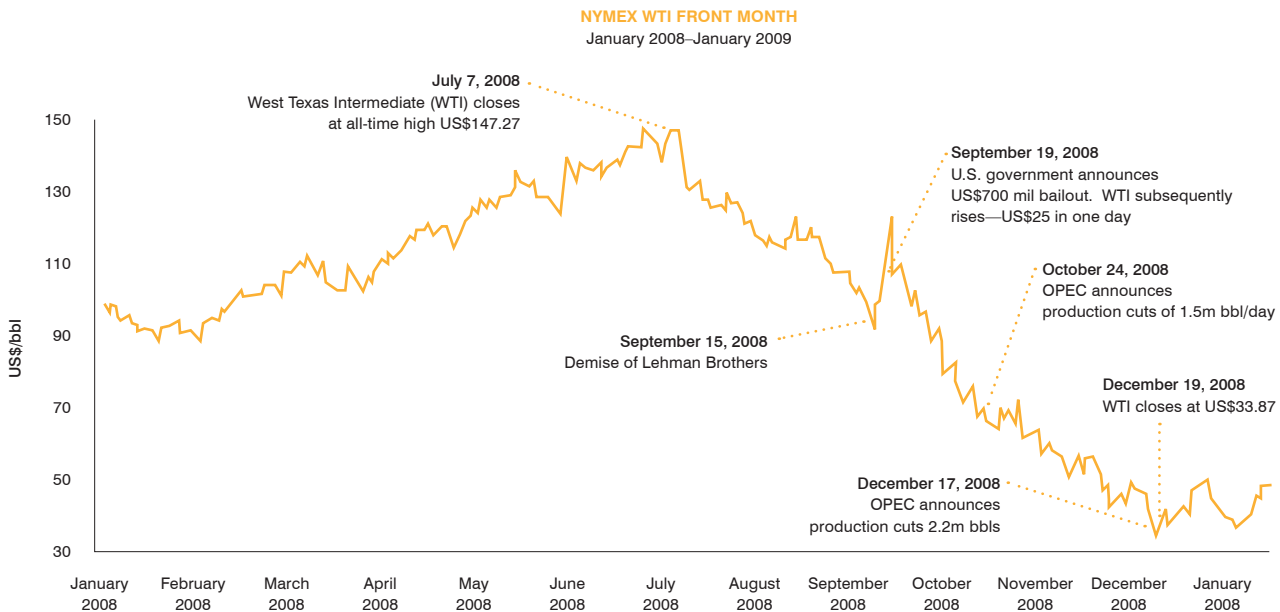
A TOUGH YEAR FOR UPSTREAM IN 2008

In July 2008, when oil prices reached US\$147 per barrel—setting a record high—some industry analysts and CEOs were forecasting a price of more than \$200 in the short term. But the short term played out dramatically differently than analysts predicted. By October 2008, the price of crude was in free fall. Driven by heightened fears of a global recession

and the subsequent impact on oil demand, the price per barrel plummeted to the low \$30s (*see Exhibit 1*).

Share prices in the oil and gas sector followed suit as the immediate impact of the price collapse shrank market valuations across the board. Robust oil prices during the first half of 2008 drove the earnings results of the super

Exhibit 1
Crude Prices Dropped Dramatically at the End of 2008



Note: Daily end of trading day price quoted
Source: Bloomberg

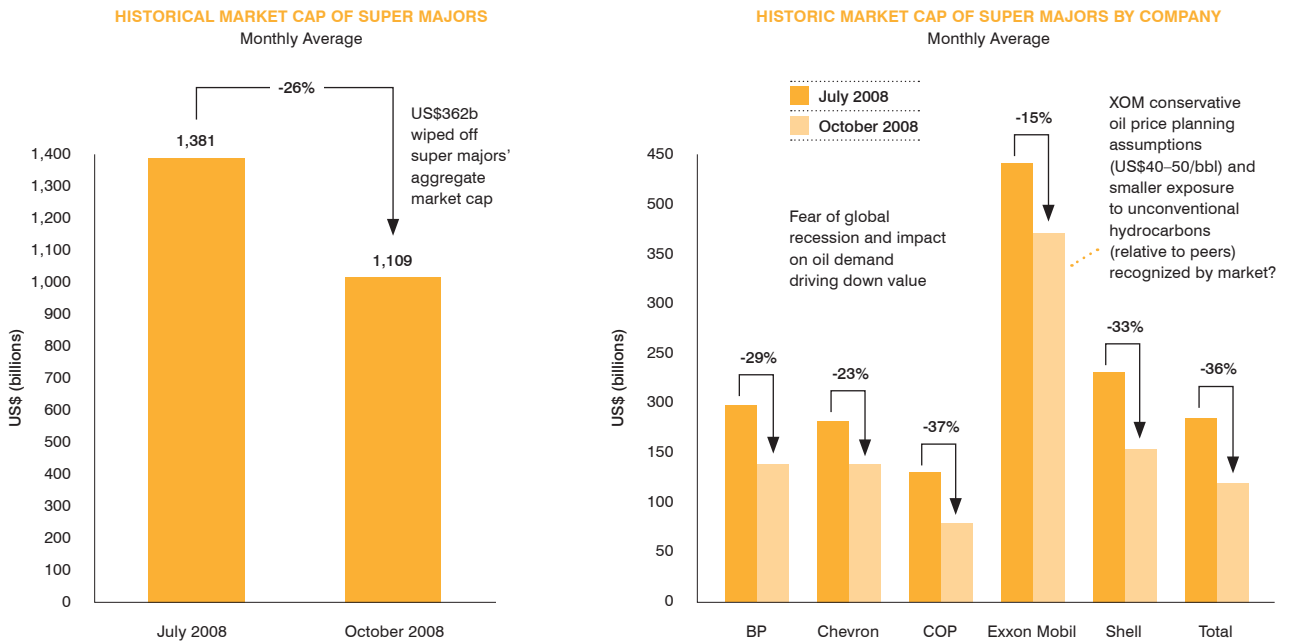
major, particularly in the upstream sector. Once the momentum died, the super majors saw \$362 billion (26 percent) of their market capitalization disappear between July and October (see Exhibit 2).

Although losses were spread across all players, some were hit harder than others. It's no surprise that Exxon

Mobil Corporation (which lost 15 percent of its market capitalization) appeared to be the least affected by the oil price decline. The company's reputation for conservative oil price planning assumptions and its conservative exposure to unconventional hydrocarbon exploration and production (E&P) projects seem to have been recognized by the market.

In contrast, Royal Dutch Shell (down 33 percent) was among the hardest hit of the super majors. Shell's broad portfolio of unconventional hydrocarbon projects and alternative energy investments appears to have spooked market investors, at least for the short term.

Exhibit 2
The Decline in Oil Price and the Market Value of Super Majors



Source: Bloomberg; Booz & Company analysis

CREDIT SQUEEZE AND PLUNGING PRICES DELIVER ONE-TWO PUNCH

Falling oil prices—on the heels of a massive global credit crunch—knocked the oil industry into uncharted waters. “We’re facing declining commodity prices and a credit crunch,” says Steve Hadden, executive vice president (EVP), exploration and production, for Devon Energy Corporation. “We’ve seen each before, but not both at the same time.”

If it were just a price decline, companies would be likely to continue their course; however, for many players the credit crunch stifles the ability to do that. Now, even a small financial problem, manageable under normal credit circumstances, could prove to be a fatal blow.

To say the industry is facing significant uncertainty would be an understatement. Long-term industry fundamentals suggest oil prices will rebound, as supply struggles to meet the inevitable post-recession pick-up in demand. Therefore, the significant challenges lie in the uncertainty of the short term. Insiders recognize several undisputable

facts: we’re in a period of enormous upheaval, massive structural changes are on the horizon that will affect all players, and the consequences will be long term.

As the fallout continues to rain down, consequences of the combination one-two punch are emerging. For many players, the make-or-break point will come down to cash flow. Funding opportunities are drying up, and access to future financing may be a struggle. We’ve seen the trend toward consolidation involving some independents in the upstream sector already begin to take shape (e.g., Oil and Natural Gas Corporation’s \$2.6 billion move to acquire Imperial Energy Corporation and China Petroleum and Chemical Corporation’s [Sinopec’s] \$1.9 billion buy of Tanganyika Oil Company). The strong cash flows of the major players (the six super majors boasted a combined \$32.3 billion at the end of October) and the national oil companies (NOCs), underpinned by sovereign credit, make them least exposed to funding issues.

SUPER MAJORS STAYING THE COURSE

Chevron Corporation's strong balance sheet is allowing the company to push ahead with a capital expenditure budget as planned. George Kirkland, Chevron's EVP of global upstream and gas, commented, "While short-term projects in the early stages of development offer Chevron scheduling flexibility, should the need arise, any project that has moved into construction will continue to move through the cycle. We'll never slow those down."¹

Total's CEO, Christophe de Margerie, echoed Kirkland's sentiments: "We don't know how long this recession will last, but the first message is 'no change.' Our first responsibility is to ensure that when the additional demand comes, we are there." De Margerie stated that Total would continue to invest in oil projects "for the medium to long term."²

Exxon Mobil chairman and CEO Rex Tillerson has indicated that the company's five-year, \$125 billion capital expenditure plan will remain in place despite the recent drop in oil prices.

Another oil major's upstream strategy VP pointed to the long-term nature of his firm's strategy: "The sensible and winning strategy is to continue to invest. We are currently sticking to our overall strategic plan, and it is doubtful that we will scale back

exploration activities in any significant way."

The super majors are aligned in their strategies to continue to invest in people and maintain and grow talent for the future. The general consensus is that because upstream projects are planned for the long term (i.e., they take an average of 10 years to complete, and they operate for approximately 30 years), the emphasis must be on future capability. "In 2008, we hired approximately 6,000 new employees, and we will continue that rate in 2009," says Susan Houghton, a human resources official at Chevron.³ Despite the drop in oil prices, BP's strategy of investing in talent remains firmly in place, including a \$50 million investment in engineering schools in Libya.

Nonetheless, as the global economic situation deteriorates further, long-term strategies may need to accommodate short-term realities. Interestingly, ConocoPhillips Company was the first of the super majors to announce publicly an 18 percent decrease in the 2009 capital expenditures budget (down to \$12.5 billion). In the words of their CEO, James J. Mulva, "We are positioning ourselves in the current business environment to live within our means in order to maintain financial strength."⁴

*"Our first responsibility is
to ensure that when additional
demand comes, we are there."*

SOME NOCS POSITIONED FOR ACQUISITIONS, BUT HURDLES REMAIN

Many NOCs are relatively unperturbed by the financial crisis. They typically benefit from strong government support and financing with little need to go to the capital markets. Moreover, given their political mandate to make overseas acquisitions to address concerns about security of supply, they are well placed to make targeted acquisitions.

Saudi Aramco's EVP of operations, Khaled al-Falih, recently disclosed that he did not expect the current credit squeeze to have an impact on the company's upstream projects, which he said were self-financed. He went on to say, "We at Saudi Aramco have operated for a long time on the principle of 100 percent financing of our own projects, and that is why the global financial credit squeeze will have virtually zero direct impact on us."⁵

Fu Chengyu, CEO of China National Offshore Oil Corporation (CNOOC) commented in November 2008 that the economic crisis provided opportunities for the company. "We feel confident... but this all depends on how we manage this opportunity. We are looking forward to the next six months."⁶

Libya's NOC revealed high aspirations with its recently announced plans to buy a stake in Eni S.p.A and its intentions to become an international oil company (IOC).

Some NOCs may use the current turmoil to exploit acquisition opportunities and target financially troubled independents struggling with funding. Both PetroChina Company and ONGC are looking at a new round of asset deals. As ONGC Chairman R.S. Sharma recently stated, "We have not slowed down. In fact, we feel it is a suitable time for stepping up the ante."⁷

However, NOCs are not impervious to the global financial meltdown. As prices plunge, pressures mount for NOCs to deliver returns that are already committed to fund massive national agendas. Moreover, despite the potential opportunities arising from the crisis, some NOCs may lack the technical expertise, managerial skill, corporate governance, and independence required to really weather the storm successfully.

IOCS CUT SPENDING, BUT TAKEOVER VULNERABILITY INCREASES

Several of the IOCs will struggle and become increasingly vulnerable to takeover, as funding opportunities dry up with the tightening credit. This may lead to growing sector consolidation. The impact of lower oil prices is likely to play out in cuts in exploration programs for these companies.

EnCana Corporation recently announced plans to cut spending in 2009 by 18 percent, and it may sell off assets to weather falling oil prices and economic uncertainty. President

THREATS AND OPPORTUNITIES

The super majors and NOCs are positioned to selectively expand their portfolios through targeted acquisitions. Reserves and acreage, as well as newly available talent, are surfacing. Opportunities to reap return on investment are beginning to emerge through renegotiated terms and licenses.

In the near term, demand is expected to cool, and supply-side prices to adjust. Current development costs are too high to sustain. This may not be an opportunity for companies that require credit but are unable to secure it. For well-funded companies, however, cooling prices suggest a strategic window of opportunity to make large investments that establish a lower-cost invested capital basis. Insiders look for this to be a big win, resulting in lower long-term costs, increased margins from future price upswings, and more staying power during future industry cycles.

Costs for basic raw materials are also expected to drop, causing a ripple across the service sector's value chain. This is a margin opportunity for those with high credit lines (increased over time to accommodate rising prices), which will be able to increase their inventory purchases as costs for raw materials decline.

Long-term strategy pros are looking beyond shortsighted goals for cost reduction, as well as keeping a close watch on the financial health of their suppliers. Greater capacity and capability is a must for the long term, and companies that plan to ride out the turbulence and emerge healthy and robust continue to aim their strategies to that end.

and CEO Randy Eresman commented, "In these challenging economic times, we are highly focused on key business objectives: maintaining financial strength, generating significant free cash flow, further optimizing our capital investments, and continuing to pay a stable dividend to shareholders."⁸

John Manzoni, president and CEO of Talisman Energy Inc., also announced plans to reduce the firm's capital spending plan. "The world has changed considerably over the past few months, and the outlook today means that we must prepare for a period of softer commodity prices driven mainly by a world economy that is slowing dramatically," he said. "The most important priority as we look forward is to maintain a high level of financial flexibility and balance sheet strength. It may prove better value to buy rather than build over the next 12 to 24 months, and we want to maintain the capacity to do that if the right opportunity comes up."⁹

NOW WHAT?

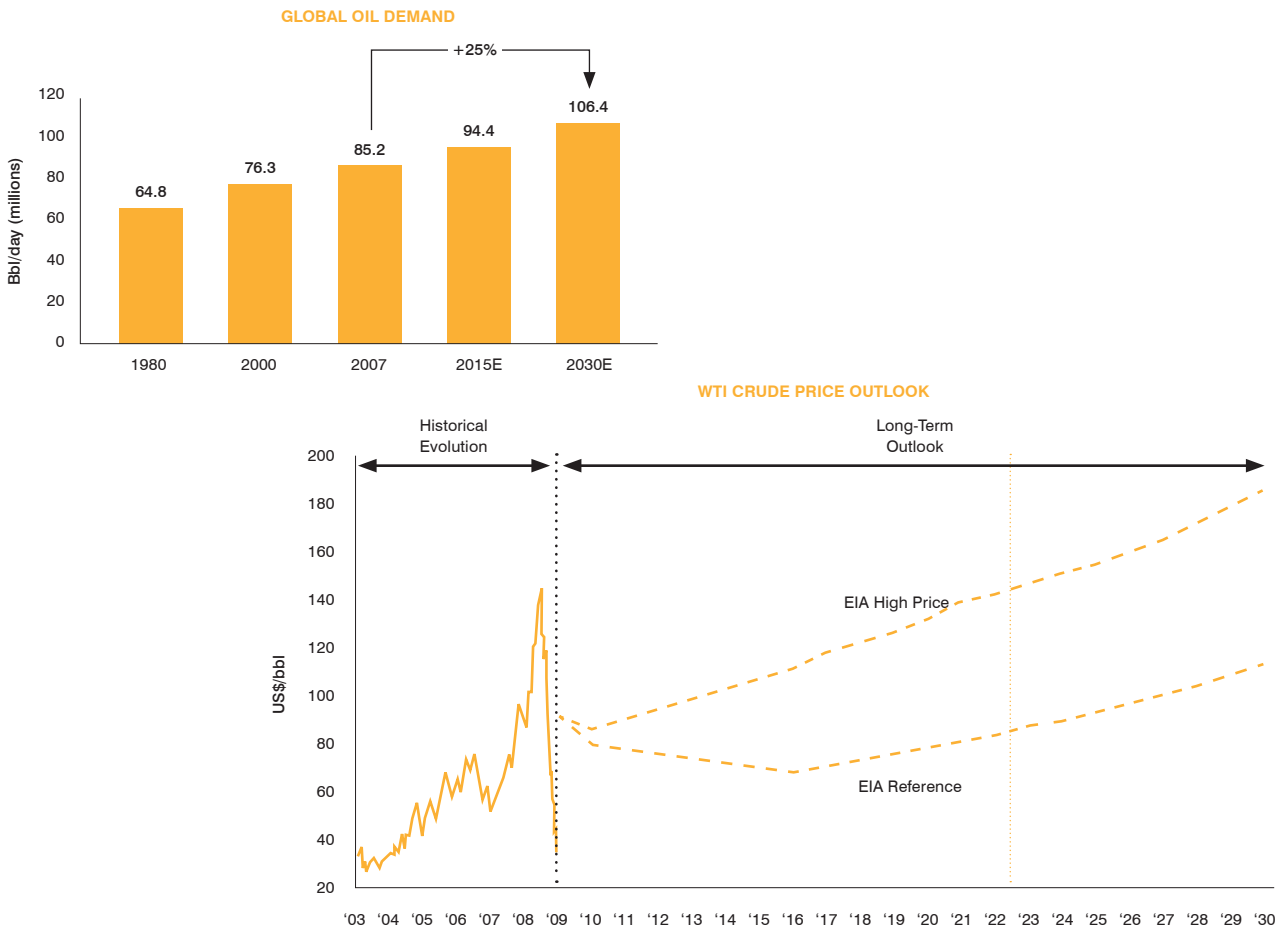
The outlook remains unclear for the global economy. Although it will take time to fully realize the impact of the credit squeeze, all indications point to a slow recovery. Industry opinions vary regarding the price of oil over the long term, but market fundamentals suggest it will be high (see Exhibit 3).

A look to the past tells us that major changes are ahead. The industry's last cataclysmic event, in the late 1990s, began with a financial crisis in Asia that sparked a drop in oil prices, shaking the industry and

causing dramatic restructuring. The most prominent consolidations that followed essentially created the super majors. Fast-forward to today—the current global credit crisis is much larger and far-reaching.

As some players brace for the turbulent times ahead, others are positioning themselves to seize strategic opportunities as they emerge. The long-term picture remains to be seen. But one glaring certainty is clearly visible: We're on the verge of seismic structural changes that will reshape the oil and gas landscape.

Exhibit 3
Increasing Demand and Prices through 2030



Source: Energy Information Administration, International Energy Agency

Endnotes

¹ Casey Sattler, "Chevron Holds Capital Spending Steady as Income Doubles," International Oil Daily, Nov. 3, 2008

² Robert Perkins, "Total Warns Companies to Keep Spending Despite Price Fall," Platts Oilgram News, Oct. 30, 2008

³ John W. Miller, "Offshore Rig Workers Call the Shots," The Wall Street Journal, Nov. 10, 2008

⁴ Loren Steffy, "Buybacks, Layoffs and Prudence," The Houston Chronicle, Jan. 21, 2009

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⁶ Paul Haven, "Crisis Could Mean Bargains for China," The Associated Press, Nov. 18, 2008

⁷ "Chinese, Indian NOCs Set To Keep Buying," Petroleum Intelligence Weekly, Nov. 17, 2008

⁸ "EnCana Plans Measured, Flexible Approach to 2009 Investment," Resource Week, Dec. 28, 2008

⁹ Dan Healing, "Talisman Net Income Soars to Record \$1.4B; Company Eyes Spending Cuts for Next Year," The Calgary Herald, Nov. 5, 2008

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