BDO 2014 ENERGY OUTLOOK

U.S. OIL & GAS INDUSTRY OPTIMISTIC FOR 2014, BUT LOOKING TO PROCEED CONSERVATIVELY

The U.S. energy sector has reason to feel optimistic heading into 2014.

The shale revolution has continued to prove prosperous for the country's economy as demand soars and prices prove favorable. And there's no indication that the momentum will slow anytime soon: The Energy Information Administration (EIA) reports that natural gas production at new wells is outpacing declines in existing wells, and that the United States is now producing more oil than it is consuming. This ongoing industry growth is buoying industry executives' sentiments for the year ahead. According to BDO USA LLP's annual survey of 100 U.S. oil and gas chief financial officers, 63 percent of CFOs feel more confident about the U.S. economy and its impact on demand for energy in 2014, a 54 percent increase from last year's study. Underlying this positivity is the continuing profitability of shale exploration and production: A plurality of CFOs (32 percent) see increased oil and gas prices as the most important factor driving overall growth for the energy industry in 2014 as the United States continues to sell its inexpensively-produced resources at high international prices.

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These findings are from the ***BDO 2014 Energy Outlook Survey***, which examined the opinions of 100 chief financial officers at U.S. oil and gas exploration and production companies. The nationwide survey was conducted from September through November 2013.

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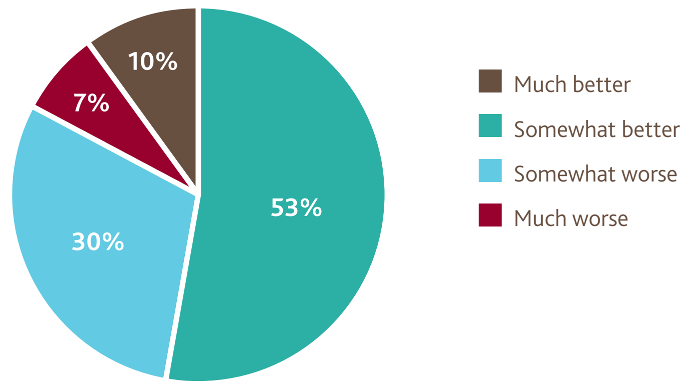
Supply and demand dynamics also continue to favor the U.S. industry. CFOs predict that accelerated production of U.S. resources will continue in the New Year, with 73 percent expecting an increase in domestic natural gas supply in 2014, and 76 percent expecting the same for domestic oil supply. Accompanying this growth in supply is an attendant growth in demand. Sixty-two percent of CFOs expect domestic demand for natural gas to increase in 2014, and two-thirds (66 percent) project that domestic demand for oil will grow, as well. Meanwhile, demand overseas continues to swell, with 65 percent and 64 percent of CFOs anticipating growth in global demand for oil and natural gas, respectively.

With CFOs feeling better about the overall economy, many also project a strong year ahead for their companies' finances. Seventy-one percent of CFOs feel better about their companies' ability to access capital and credit in 2014 as compared to 2013, a 20 percent increase over last year's study. While healthy international demand is a major driver of this confidence, improvement in the capital markets may also be a contributing factor.

"Oil and gas executives can feel relatively secure in their finances this coming year as the U.S. energy industry continues to gain momentum," said Charles Dewhurst, partner and leader of the Natural Resources practice at BDO. "Not only is our economy improving, but with demand exploding worldwide, new doors are opening for increased revenue. We are seeing significant foreign investments flowing into U.S. assets, as well as a growing need for U.S. oil and gas globally—and the price differential is quite favorable for us."

Compared to last year, how do you feel about the U.S. economy and its impact on demand for oil and gas?



▶CFOs PRIORITIZE EFFICIENCIES OVER EXPANSION

Despite strong economic signals, CFOs are planning to proceed cautiously, prioritizing efficiencies over expansion. CFOs expect merger and acquisition (M&A) activity to stabilize in 2014, with more than half anticipating no change in deal flow and 43 percent expecting an increase. This contrasts with last year's projections, when 53 percent of CFOs expected to see a rise in M&A activity. CFOs have likely been chastened by slowed deal flow in 2013. 2012 saw a torrid deal pace, with energy industry consultancy PLS, Inc. reporting $83 billion in U.S. deals; as of Q3 2013, however, the U.S. had seen only $34 billion worth of activity. A plurality of CFOs (38 percent) expect that the primary driver of M&A activity in 2014 will be increasing revenue and profitability, as opposed to undervalued oil and gas assets (27 percent) or a desire to increase market share (15 percent).

In an effort to entrench the gains of recent years, companies are looking inward to streamline operations and reduce costs in 2014. When asked how they plan to bolster profitability, one-third of CFOs cite improving internal business processes as a top tactic. Only a quarter anticipate investment in new technologies, while a mere nine percent plan to pursue vertical integration through acquisitions. Nearly one-in-four CFOs expect to scale down their business: 12 percent plan to reduce exploration, while 11 percent cite staff cuts. In addition, a plurality (38 percent) say they will pursue cost reduction programs in an effort to increase value for stakeholders, a 58 percent jump from last year's study. These cost-cutting moves suggest that despite considerable growth, particularly in 2012 and 2013, the energy industry is looking to right-size operations and become more nimble to manage potential future challenges.

▶PRIVATE EQUITY INCREASES ITS SHARE OF INVESTMENT

In order to fund these efficiencies, as well as to drive the M&A activity that does take place in the coming year, 45 percent of CFOs plan to use traditional debt financing as their primary outside capital source. But private equity is keeping pace. Forty percent of CFOs plan to tap private equity funds in the coming year to finance their activities. Private equity is becoming an increasingly important way not only for companies to finance capital improvements and infrastructure development, but also for investors to take advantage of the strong ROI offered by the United States' ongoing shale renaissance.

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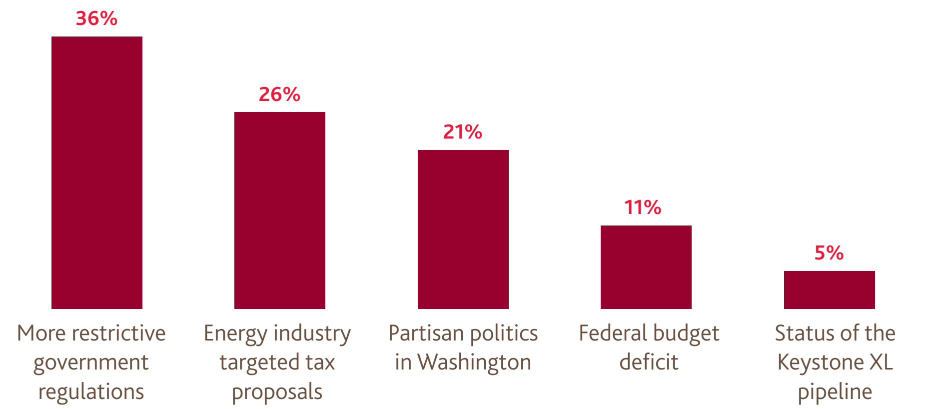
"The oil and gas industry—especially oil—is ripe for private equity investment," stated Jim Westerman, partner in BDO's Private Equity and Natural Resources practices. "Oil prices and the costs of discoveries and operations have largely stabilized in recent years, in part due to technological developments and the general characteristics of shale. This is generating increased interest from private equity sponsors eyeing the industry for significant returns on investment. Correspondingly, we're seeing more and more oil company CFOs turn to the private equity industry as a viable source of capital in 2014 and beyond."

▶LEGISLATION AND REGULATION TOP LIST OF CONCERNS

While energy CFOs are confident for a prosperous 2014, they remain conscious of challenges facing the industry. A majority of CFOs (53 percent) believe legislative changes will be the top factor inhibiting overall industry growth in 2014—no surprise when over half (52 percent) indicate that legislation had been responsible for E&P project terminations or delays in 2013. Despite these uncertainties, however, CFOs remain confident that their bottom lines will be able to weather any pending change: Only 31 percent expect legislative changes to be their greatest financial challenge in 2014.

Regulations also remain top of mind for CFOs. A plurality of CFOs (36 percent) cite regulatory changes as a top political concern for 2014, and over two-thirds of survey respondents indicate that Federal and state-level regulations had led to project terminations or delays last year.

Top Political Concerns



Additionally, CFOs are keeping a wary eye on potential energy industry-targeted tax proposals, with 26 percent of respondents noting these as their primary political concern. CFOs are particularly concerned about the potential loss of the tax deduction for intangible drilling costs: More than half (53 percent) cite it as their leading tax concern in the New Year. Though this is down slightly from last year, it overwhelmingly outpaces other tax issues, with percentage depletion (19 percent) and loss of the domestic manufacturing deduction (nine percent) coming in a distant second and third.

"The regulatory uncertainty the energy industry experienced in the run-up to the 2012 election has only slightly abated," noted Clark Sackschewsky, partner with BDO's Natural Resources practice. "The IDC deduction is one of the largest tax breaks available to these companies, and as budget debates continue on the Hill, energy executives are concerned that it might end up on the chopping block."

▶EXECUTIVES ACCEPT ENVIRONMENTAL RESPONSIBILITY IN THEIR CORPORATE PLANS

Environmental regulations pose a particularly compelling challenge to the industry as the government grapples with tough questions about hydraulic fracturing (fracking), carbon emissions and the status of the Keystone XL pipeline. This year, more than half of CFOs (54 percent) say they will focus their risk management activities on environmental regulation, and nearly one-in-three (30 percent) cite the impact of fracking as primary environmental concern for 2014.

Yet rather than shying away from the public debate, CFOs are accepting environmental stewardship as a core part of their corporate plans, and are increasingly seeking environmentally responsible ways to exploit U.S. oil and gas resources. Sixty-one percent of CFOs indicate that they plan to increase their capital investment in environmentally-friendly E&P processes in 2014, a 15 percent jump from last year's study. While 60 percent of CFOs similarly anticipate increasing their investment in non-conventional resources, this suggests that environmental responsibility and increased production have become interconnected for many U.S. oil and gas companies. Even as new shale plays, such as the Tuscaloosa Marine Shale, gear up for drilling, it is clear that energy companies are seeking ways to maximize production while securing buy-in from the government—state, local and Federal—as well as local communities.

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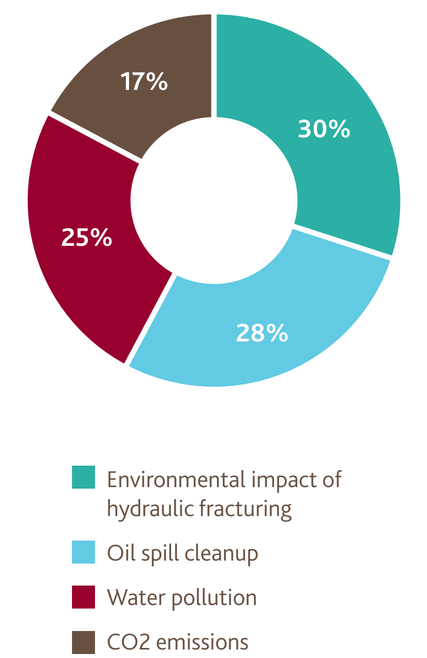
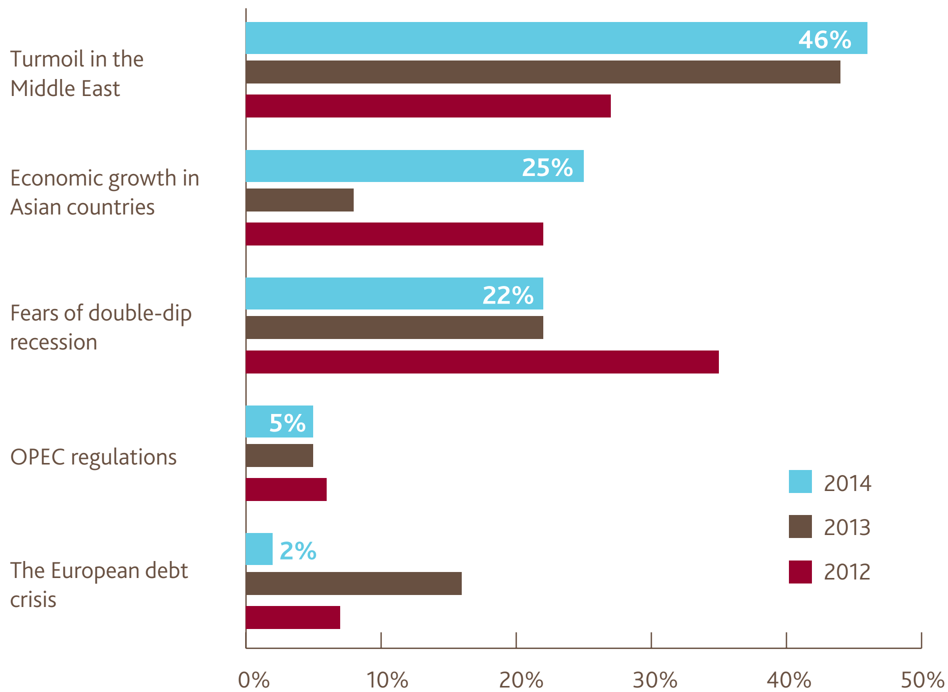
Top Environmental Concerns



Top Factors Influencing Oil and Gas Prices



"These companies plan to devote a significant amount of resources to environmental issues," Dewhurst told *Energy Metro Desk*. "Companies are very interested in getting their side of the story out there, to take ownership of the fracking story, to show what the industry itself is doing to self-regulate."

Carbon emissions are a lesser concern for CFOs at this time, with only 17 percent citing them as a top environmental challenge. Nevertheless, many major producers, such as ExxonMobil and BP, are now incorporating the cost of a potential carbon emissions tax in their long-term financial plans. This suggests that while fracking is the most pressing near-term issue for the U.S. energy industry, climate change remains a compelling long-term priority.

INDUSTRY CLOSELY MONITORING INTERNATIONAL DEVELOPMENTS

Though CFOs are confident that they will benefit from high oil and gas prices in 2014, they do worry about the potential effects of international events: a plurality (46 percent) of CFOs cite ongoing turmoil in the Middle East as having the greatest impact on oil price volatility as conflicts continue in the region and Iran plans to ramp up its oil production once sanctions ease.

One-quarter of CFOs also express concern that economic growth in Asian countries will be a major influencer of oil price fluctuations—more than a three-fold increase over last year's study. While these countries are currently reliable customers for U.S. oil and gas resources, many are accelerating their domestic energy programs in an effort—not unlike the United States'—to secure energy independence and to diversify their sources of electricity generation. For example, China continues to seek ways to tap its vast shale reserves (which are considerably more difficult to access than North American shale), while Japan, still recovering from 2011's Fukushima disaster, works to extract natural gas from methane hydrate in the Pacific. The U.S. industry may expect to see falling prices for its goods as new international energy sources come online.

LABOR COSTS ARE ON THE RISE

Despite the fact that most CFOs (63 percent) don't anticipate increasing the number of personnel they employ in the next year, 49 percent of CFOs expect their labor costs to grow by as much as 15 percent in 2014, and 12 percent expect to see increases exceeding 15 percent.

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"The labor market hasn't yet caught up to the growth of the U.S. oil and gas industry," according to Lance Froelich, senior director of compensation consulting in the Global Employer Services group and a member of BDO's Natural Resources practice. "A very significant percentage of open positions are being filled by buying talent, and this phenomenon is driving salaries, sign-on incentives and special perquisites higher."

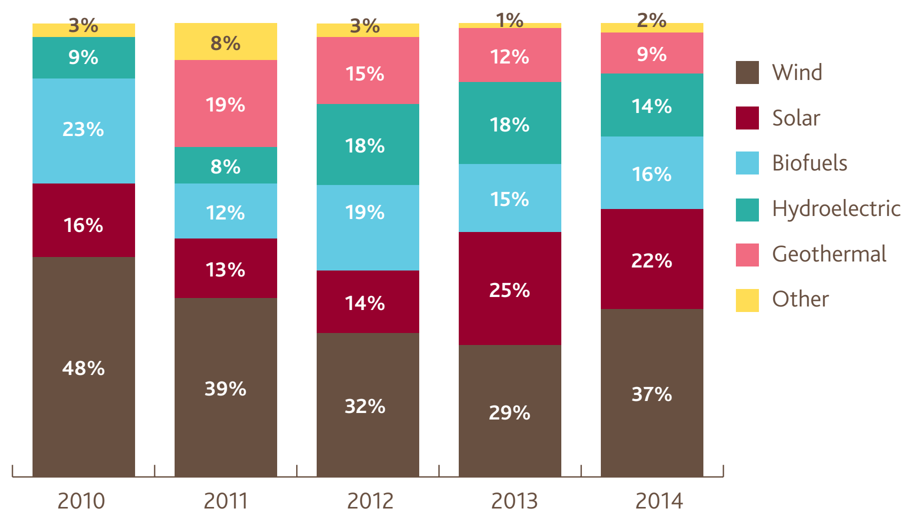
In regard to fiscal year 2013 employee bonuses, 20 percent of CFOs expect to see an increase in award amounts over 2012 while 56 percent expect that performance will support bonus budgets at the same level as fiscal year 2012. Meanwhile, almost one-third of CFOs expect their own compensation will increase in 2014 while 64 percent expect it to be comparable to 2013. "Over the past three years, corporations have expended a great deal of effort in structuring the compensation for CFOs and other officers around challenging performance incentives. These survey results indicate CFOs' optimism that they will meet or beat results achieved in 2013," said Froelich.

▸WIND IS MOST PROMISING ALTERNATIVE ENERGY TECHNOLOGY

For the fifth year in a row, CFOs project that wind power will dominate the alternative energy space, with a plurality (37 percent) expecting it to contribute the most to the world's future energy needs. This marks a nearly 28 percent increase from last year, yet is still lower than our 2010 survey, in which nearly half of the CFOs surveyed cited wind as a leading alternative energy source. Over the past four years, CFOs have largely equalized their expectations of various alternative energy options, and their opinions have remained relatively stable year-over-year. This suggests that as the shale boom continues, oil and gas executives are focused more on the clean energy potential of U.S.-produced natural gas and have reprioritized accordingly.

2014 is poised to be another strong year for the U.S. energy industry. Though the industry will always face perennial challenges like oil price volatility, CFOs are wisely looking to solidify gains while planning carefully for the future. It is clear that non-conventional resources like shale will continue to be a major driver of growth, and the United States economy stands to benefit from this sector's prosperity.

Which Alternative Energy Source Do You Expect to Contribute Most to the World's Future Energy Needs?



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