SUMMER 2015
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THE NEWSLETTER OF THE BDO NATURAL RESOURCES PRACTICE

NATURAL RESOURCES RECORD

CERAWEEK 2015 EXAMINES WHAT'S IN STORE FOR THE U.S. ENERGY INDUSTRY

By Charles Dewhurst

This past April, I had the pleasure of once again attending the annual IHS CERAWeek conference. This year's event continued to explore themes that emerged during the 2013 and 2014 conferences – namely, the United States' evolution as a major energy producer and what that means for the global industry – but the mood was somewhat tempered by the challenges the sector has faced over the past year. Political inertia, oil price volatility, shifting global dynamics and slowing discoveries in the United States have left many energy industry executives asking, "What's next?"

UNITED STATES STILL DETERMINING THE WAY FORWARD IN THE INTERNATIONAL MARKET

After many years of unprecedented growth, the U.S. oil and gas industry is being slowed by legislative inertia and a lack of a coherent energy policy. Many speakers at CERAWeek, including Senator Lisa Murkowski (chairwoman of the U.S. Senate Energy & Natural Resources Committee), described the challenges government officials must address in order to capitalize on the country's newfound energy independence.

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DID YOU KNOW...

The ***Energy Information Administration*** forecasts U.S. crude oil production to reach 9.2 million barrels per day in both 2015 and 2016, 0.5 percent and 1.1 percent lower, respectively, than the organization's May 2015 short-term outlook.

In its *Global Trends in Oil & Gas Markets to 2025* report, ***Lukoil*** predicts that global demand for liquid hydrocarbons will continue to grow annually by 1.2 percent, and is projected to reach 105 million barrels per day by 2025.

In its 2016-2018 Brent price forecast, ***Goldman Sachs*** predicts that prices for crude oil will settle at $65 per barrel.

According to the ***2015 BDO Oil and Gas RiskFactor Report***, 84 percent of the top 100 publicly traded E&P companies cited accounting-related risks, such as maintaining internal controls and complying with accounting regulations, as a major concern for 2015.

ExxonMobil expects that increases in global energy demand through 2040 will be largely driven by China and India, accounting for 30 percent and 20 percent of growth, respectively.

The ***Federal Energy Regulatory Commission's Office of Energy*** reports that wind, solar, geothermal and hydropower provided more than 84 percent of the 1,900 megawatts of new electricity generating capacity in the United States in the first four months of 2015.

CONTINUED FROM PAGE 1

CERAWEEK 2015

Of particular concern is how the United States can continue to market its oil and natural gas products, including liquefied natural gas (LNG). In terms of oil, U.S. pipeline infrastructure is in dire need of repairs and expansion. In the absence of sufficient pipeline capacity, many producers ship their product via rail or truck, which entails significant risk – in the first half of 2015, a number of trains carrying crude oil have already derailed, imposing major environmental and safety hazards. At the same time, our pipelines are beginning to show their age. Most recently, a pipeline in Santa Barbara burst, spilling thousands of gallons of oil into the Pacific and highlighting the need to shore up our existing transportation infrastructure. Amid these difficulties, the Keystone XL Pipeline remains stuck in legislative limbo, hindering efforts to facilitate the North American oil trade.

The process for exporting U.S. oil and gas resources remains inefficient, as well. The long-standing ban on crude oil exports leaves many energy companies with significant stores of oil that cannot be used in the United States due to the refining backlog. At the same time, the LNG export permitting process continues to be slow and ineffective, further limiting the industry's ability to take advantage of eager markets abroad.

In other words, though the U.S. energy sector has made major strides in the past decade, our energy policy has not yet caught up to this growth, creating inefficiencies and preventing the U.S. economy from fully benefiting from the North American energy renaissance.

LOW OIL PRICES A DOUBLE-EDGED SWORD

While declining oil prices have troubled the energy industry over the past year – in our *2015 Energy Outlook Survey*, the CFOs of leading U.S. E&P companies cited low oil prices as their top financial challenge – CERAWeek highlighted that the outlook may not be as gloomy as it once seemed. Oil price fluctuations are inherent to the industry, and the high prices we enjoyed between 2012 and early 2014 were actually somewhat atypical. We are seeing prices begin to stabilize again, growing from a low of about $43/barrel in mid-March to approximately $60/barrel in May.

This pricing reset serves as an opportunity for the industry to right-size and control costs, particularly among service companies that raised prices to capitalize on booming production over the past few years. Moreover, lower crude prices have decreased the cost of energy for consumers, leaving them with more money to spend elsewhere and to stimulate the broader U.S. economy.

GLOBAL ECONOMY AND GEOPOLITICS GENERATE UNCERTAINTY

In years past, CERAWeek attendees and speakers expressed optimism about growing energy demand in China and how North American companies may be poised to fulfill this need. However, this year, concerns about China's unsustainable debt growth emerged – some speakers fear that China is on the verge of a "lost decade" of low growth, similar to the stagnation Japan experienced in the 1990s. A stalling of the Chinese economy could have across-the-board implications for many global markets, including the natural resources sector. North American energy companies (in particular Canadian companies, some of which have forged strategic partnerships with Chinese energy firms) could lose an important customer, and Chinese efforts to exploit its own shale resources may experience significant setbacks.

Political uncertainty also looms, with the Middle East remaining a major inflection point. Though OPEC may no longer be the industry power player it once was, supply concerns persist. The future of the Iranian oil sector is unclear in the absence of a strong indication of if and when the global community plans to lift economic sanctions, but the return of Iran's oil to global markets promises to shift trade dynamics. Additionally, the rise of ISIS in a number of oil-producing Middle Eastern countries, including Iraq, is proving disruptive to all levels of operations, from production to refining to marketing.

In spite of these challenges, there are some bright spots in the global economy. The United States and U.K. are enjoying a solid rebound, and Canada is on the precipice of turning its own lagging economy around, as well.

CAN THE SHALE GAME LAST?

Shale reserves generally have a shorter life span than conventional oil and gas reserves, and the United States may be in the early stages of shale's decline. According to IHS, the number of newly discovered oil and gas reserves reached a 20-year low in 2014, and CERAWeek attendees expect to see this number decrease further in years to come.

Though the natural life of these reserves plays an important role in this decline, there may be additional factors influencing this trend. Low oil prices are making it difficult for E&P companies to develop new reserves – drilling new wells may be an uneconomical proposition in general, and companies are having a hard time acquiring the personnel they need for these operations. Moreover, 2012 and 2013 were major investment years for E&P companies, with reserve additions proving strong among the middle market. At some point, the pace of discovery needed to slow as the number of available prospects decreased, and as companies worked to recover their existing reserves.

In last year's CERAWeek recap, I wrote that the energy industry was optimistic about growth in the face of emerging challenges. However, this year, it became clear that many of these challenges came to a head more quickly than anticipated. The good news is that the industry remains resilient, and if it takes this time to reset and assume a longer-term view, it is poised to emerge as strong and vital as ever.

For more information, please contact Charles Dewhurst, Leader of the Natural Resources practice, at cdewhurst@bdo.com.

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BDO SPOTLIGHT:

Executive Q&A with Tom Smith, State and Local Tax

Tell us a bit about your role at BDO. How did you become interested in your line of work, especially your work in the Natural Resources industry?

I'm currently a partner with BDO's Oklahoma office, overseeing State and Local Tax for the Southwest region. My work with the oil and gas industry began more than 25 years ago, and my interest in the sector developed very early on in my career. Right out of college, I joined the Texas Comptroller's Oklahoma field office as an auditor for oil and gas companies doing business in Texas, but whose corporate headquarters were located in Oklahoma. It was a great experience as a young professional, allowing me the opportunity to audit some of the largest companies not only in the sector, but in all of the United States. It provided an in-depth education on the inner workings of the oil and gas industry. I was able to see firsthand the rapid growth of the U.S. energy sector, the development of innovative exploration and production techniques and the increasing importance of renewables as a complement to fossil fuels.

How can companies navigate today's uncertain commodities market? Are there any tax incentives that can help?

Balancing the ups and downs of a historically volatile energy market is a complex challenge for E&P companies. When the industry is booming and demand is healthy, companies are paying bills as fast as possible and are less concerned with the specifics of their tax burdens. They have the funds to pay their bills and can continue making strategic investments for future business growth. When there is a downturn, however, the focus is on the bottom line and taxes can become a key area of concern. During the good times, we're there helping companies find efficiencies and opportunities to reinvest in the business. During the bad times, we can help companies determine which cost-saving mechanisms can help keep expenses under control, and actually recover taxes overpaid in prior periods.

Taking advantage of tax incentives can be particularly tough in this environment – so many are tied to investing and hiring, both of which decline in slow markets. Part of our job is to help these companies identify the right incentives and execute a plan that takes into account budgetary limits.

What steps should oil & gas companies take to improve their local tax planning, both in general and in today's market?

As the industry evolves, it's important that companies plan ahead for possible downturns and decide which investments will best position them for future growth and stability. Organizations should maintain a long-term perspective, constantly reviewing incentive positions, highlighting areas of exposures and savings within their compliance structure, and identifying business systems issues before they balloon into larger problems. This proactive approach helps companies weather volatility and locate savings opportunities for times when revenues might be leaner. In particular, companies should strategically plan their future drilling operation locations to take advantage of local tax incentives and credits – savings don't only lie in federal programs.

How would you describe the impact of the work you do for your clients?

Our tailored approach and in-depth industry knowledge help our clients achieve their business objectives. We know each client is a distinct entity with unique needs, and it is imperative for us to understand what makes them tick – as well as the specific industry challenges they're facing. We aim to provide strategic guidance, regardless of whether the market is up or down, to meet client needs and deliver the resources necessary for survival. Whether it's through recovering savings from a tax perspective or presenting innovative ways to maximize tax efficiencies, we want clients to have the confidence that our service approach is consistent with their goals.

What lies ahead for BDO's Natural Resources practice?

BDO has expanded considerably in the Southwest region, and with that growth comes more robust capabilities. My department alone has more than doubled its headcount over the past year, and we have state and local tax professionals in all of our Texas offices, including Houston, Dallas and Fort Worth. More broadly, we now have a number of professionals with very niche skill sets, such as people who specialize in complex property tax issues for oil and gas companies. It's a very exciting time to be in this business. We're growing our footprint and our services, which is nothing but good news for the clients we serve.

For more information, please contact Tom Smith, Partner with BDO's Oklahoma office, at tasmith@bdo.com.

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OIL AND GAS EXECUTIVES SEE A BRIGHT FUTURE FOR THE NORTH AMERICAN MARKET

By Charles Dewhurst and Bill Penczak

The future of the North American oil and gas market looks bright despite the dampening effects of low commodity prices.

Lingering depressed prices have taken their toll on the industry over the last year, but many industry executives see it merely as a short-term challenge that provides the industry with an opportunity to right-size. These were the sentiments expressed during a roundtable discussion with oil and gas executives at BDO Canada's Fourth Annual BDO Energy Roundtable Discussion, which was held in Calgary this past March.

COMMODITY PRICE VOLATILITY SLOWS DEAL ACTIVITY, BUT BRIGHT SPOTS EMERGE

Low prices have slowed exploration activities and created a challenging deal environment as oil and gas company valuations trend downward. In fact, according to the latest BDO USA *PErspective Private Equity Study*, 53 percent of private equity fund managers believe natural resources & energy is one of the industries most likely to experience decreasing valuations this year. Adding to the uncertainty is a lack of confidence about where pricing will go. One major international oil company estimates that prices will even out around $50 per crude barrel (BBL), while OPEC believes prices will stabilize at $60/BBL, and investment bank Tudor Pickering estimates that pricing will hit $80/BBL by the end of 2016. Uncertainty, combined with a depressed environment, have made it difficult for buyers and sellers to agree on pricing for deals. While buyers may be eager to capitalize on current low valuations, many sellers remain reluctant to let go of assets they bought during a peak market. As a result, more companies are turning to less risky joint ventures to grow their businesses.

But signs of life are now emerging in the North American deal market. Noble Energy's $2 billion announced acquisition of Rosetta Resources Inc. set off a flurry of excitement, with industry observers hoping that the move might pave the way for more shale-focused deals, according to Reuters. This follows on the heels of Royal Dutch Shell's announcement in April that it plans to buy BG Group for $70 billion, taking advantage of the firm's financial troubles and the strong opportunities that lie with liquefied natural gas.

TIME TO GET THE HOUSE IN ORDER

One attendee mentioned that "greed negated planning" in recent years as companies focused on short-term gains, rushing to grab land assets to the detriment of investment in midstream activities. Rapid growth in the marketplace inflated the price of exploration activities, with welders earning as much as $240,000 annually. Now that oil prices have dropped and exploration activity has simmered, costs are starting to level-set again. For example, the cost of a rig is down 40 percent. This dynamic is also fueling conversations about how oilfield service company pricing models might change to help the industry achieve equilibrium.

The concept of "lump sum engineering" versus the traditional hourly service model sparked an interesting conversation during the event's roundtable discussion. Most participants believe that today's economics will slowly choke off engineering firms' time and materials compensation models of the past; but to succeed, there must be a requisite level of trust on both sides. Joint ventures again prove valuable in this fluctuating environment as suppliers and operators increasingly seek these arrangements.

GLOBAL DEMAND REMAINS STRONG

With commodity prices slowing exploration activities, roundtable participants also discussed changes to global demand for oil and gas, as well as the impact of alternative energy as a viable source for the future. Analysis presented at a recent Bloomberg New Energy Finance summit highlighted that the world is now adding more capacity for renewable energy each year than coal, natural gas and oil combined. And the shift is expected to accelerate, with more than four times as much renewable capacity added by 2030.

Read more

CONTINUED FROM PAGE 4

NORTH AMERICAN MARKET

Renewable energy may slowly gain a greater share of the energy mix, but traditional energy sources remain the most likely source for meeting global demand. The World Energy Outlook 2014 estimates that global energy demand will grow by 37 percent by 2040, with the energy supply mix divided nearly equally into four parts: oil, gas, coal and low-carbon sources. North America and Europe will continue to see strong demand, and China is expected to become the largest oil-consuming country by the early 2030s.

A SHIFTING TIDE FOR PRODUCTION

North America is certain to play a major role in future oil and gas production to meet this burgeoning demand. Although oil companies have been eager to extend the success of shale development overseas, *The Wall Street Journal* reports that many are pulling back on their operations in Europe, Russia and China because of the worldwide collapse in crude prices and the slow pace of development. And OPEC's guarantees of production have become more unreliable. Roundtable participants discussed that a "flight to quality" is taking place, where companies are increasingly assessing the "reasonableness factor" – with regard to political stability and societal issues – before entering new territories. Countries such as Russia, Argentina, Venezuela and Nigeria possess significant reserves, but will be approached with greater caution in favor of more stable operating environments – despite the heavy regulatory burdens associated with operating in these less volatile territories.

Overall, the roundtable event helped reinforce the powerful role North America has played in the shifting dynamics of the global energy industry. Though many challenges remain for oil and gas businesses around the world, U.S. and Canadian companies are finding innovative ways to navigate these choppy waters and prepare for sunnier times ahead.

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PErspective in NATURAL RESOURCES

Many PE firms were hit hard by the almost 50 percent drop in crude oil prices between June and December last year. In the fourth quarter of 2014, Kohlberg Kravis Roberts (KKR) wrote down the value of its energy investments by about $225 million, or about 24 percent below cost, according to *The Wall Street Journal*. Apollo Global Management and Carlyle Group also took losses, but Blackstone was luckier, as it had previously divested $6 billion in oil-related assets at very high multiples, the *WSJ* reports.

Q4 2014 and Q1 2015 were slow in terms of closing deals, but with the price of crude still scarcely more than half what it was a year ago, many PE firms had expected a fire sale in exploration & production (E&P) assets by now. However, so far this year, acquisition opportunities have not been as plentiful as predicted. Convinced oil prices will rebound, E&P firms have preferred to hold on to key assets – and have turned to the debt and public markets instead to boost liquidity.

With buyout activity down, PE firms with mountains of dry powder for energy deals have turned to alternative transactions like buying into company debt or buying securities through private investment in public equity (PIPE) deals, *Oil and Gas Investor* reports. A February *Wall Street Journal* blog post reported that KKR, despite previous losses, had $5 billion in dry powder for energy transactions, and was mostly looking at private credit opportunities. According to *Forbes*, Blackstone has $9 billion set aside for energy investment and EnCap and Warburg Pincus have set aside $5 billion and $4 billion respectively. PE firms have lent capital especially to smaller players where banks would not – and non-energy PE firms have become increasingly interested in the space, sensing growing opportunity, according to *Forbes*.

However, E&P firms can only hold on to assets for so long in this negative cash flow environment. Raising debt and equity has increased liquidity for the time being, but this is only a stop-gap measure. If prices do not rebound by the end of the year – or even if they stabilize – some experts believe E&P firms will have no choice but to start divesting, low-quality assets first and higher-quality shortly thereafter, *Oil and Gas Investor* reports. PE firms are poised to pick up deals when that happens.

One area where deals are still taking place is the less mature, highly leveraged shale oil and gas sector. *Forbes* reports increased PE activity in Houston as PE firms look for smaller, less established shale energy players that are struggling in the down market. According to *Reuters* data, energy assets worth $112 billion are up for sale globally. Half are North American, and most of these are U.S. oil and gas shale fields such as Anadarko Petroleum's Wyoming field, according to *Oil and Gas Investor*.

PE activity has certainly been affected by price volatility in the energy sector, but opportunities are still to be found whether in the shale subsector or in the alternative investment space. And if the price of oil does not recover soon, PE firms might yet get the fire sale they have been waiting for.

PErspective in Natural Resources is a feature examining the role of private equity in the natural resources sector.

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MARK YOUR CALENDARS

The following is a list of upcoming conferences and seminars of interest for natural resources executives:

JUNE 2015

June 24-25
REFF-Wall Street Renewable Energy Finance Forum
Grand Hyatt New York
New York City

June 25-26
Platts 12th Annual Bunker and Residual Fuel Oil Conference
Omni Hotel
Houston

JULY 2015

July 8
IPAA/TIPRO Leaders in Industry Luncheon
Petroleum Club of Houston
Houston

July 14-16
Oklahoma Independent Petroleum Association Annual Meeting
Four Seasons Resort
Las Colinas, Texas

July 20-22
Unconventional Resources Technology Conference
Henry B. Gonzalez Convention Center
San Antonio

AUGUST 2015

August 2-4
Kansas Independent Oil & Gas Association Annual Meeting
Hyatt Regency at Century II
Wichita, Kan.

August 10-12
Optimizing Fractures (and Refracs) in a Low Price Environment Conference
Colorado School of Mines
Golden, Colo.

August 17-21
The Oil & Gas Conference
Westin Downtown
Denver

August 27
North Dakota Oil Pac Golf Tournament
Bully Pulpit
Medora, N.D.

BDO'S NATURAL RESOURCES INDUSTRY PRACTICE

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