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Revisiting Our Price Estimates For Large Independents Amid Lower Crude Prices

Trefis Team (http://blogs.forbes.com/people/trefis/) , Contributor

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We recently revisited our price estimates for the large independent oil and gas companies we cover to account for the change in our long-term forecast for crude oil prices. We now believe that the recent decline in oil prices could sustain for a longer period amid a slower demand growth scenario and the weakened price controlling power of OPEC (Organization of Petroleum Exporting Countries). According to our estimates, annual average crude oil price (Brent) could bottom out around $80-85 per barrel by 2017 and rise back to $100 per barrel by 2020. (See: Where Are Crude Oil Prices Headed In The Long Run (http://www.trefis.com/stock/xom/articles/270141/where-are-oil-prices-headed-in-the-long-run/2014-12-17))

Since the independent oil and gas companies do not have downstream operations, they are relatively more exposed to the volatility in global crude oil prices, compared to the integrated players like Exxon Mobil (http://finapps.forbes.com/finapps/jsp/finance/compinfo/CIAtAGlance.jsp?tkr=xom&tab=searchtabquotesdark). This also reflects in the fact that the S&P Oil and Gas Exploration and Production Select Industry Index has declined by almost 43% since the WTI crude oil prices peaked at around $100 per barrel in June, while the NYSE Arca Oil & Gas Index, which includes both integrated and independent players, has declined by just 23% over the same period. This is because, unlike the integrated players, these companies do not have a relatively stable stream of cash flows from refining and chemical production operations. This means that in a commodity down cycle, such as this one, these companies see a sharp decline in their operating cash flows, which lowers their capacity to invest in future production growth. Therefore, capital expenditure (which is the biggest single cash expense item in this business and

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the primary driver for future production and earnings growth) plans of independent exploration and production companies are far more dependent on the short to medium term outlook for global crude oil prices.

Therefore, the key fundamental value drivers – for large independent oil and gas companies – that are expected to be impacted the most because of the recent change in the oil price environment – apart from average price realizations – are exploration and production margins and annual capital expenditures. Below, we briefly discuss how the two key drivers could trend going forward.

See Our Complete Analysis For ConocoPhillips

(http://finapps.forbes.com/finapps/jsp/finance/compinfo/CIAtAGlance.jsp?tkr=cop&tab=searchtabquotesdark) | Anadarko Petroleum (http://finapps.forbes.com/finapps/jsp/finance/compinfo/CIAtAGlance.jsp?tkr=apc&tab=searchtabquotesdark) | EOG Resources (http://finapps.forbes.com/finapps/jsp/finance/compinfo/CIAtAGlance.jsp?tkr=eog&tab=searchtabquotesdark)

Thinner E&P EBITDA Margins

Despite the volatility in crude oil prices, costs associated with the exploration and production of hydrocarbons have risen consistently over the last few years. This is primarily because of the fact that it has gotten increasingly difficult to find and develop hydrocarbon reserves. According to the latest oil and gas reserves study published by EY, finding and development costs that include the costs associated with unproved property acquisition, exploration, and development of proved reserves, increased at more than 14% CAGR between 2009 and 2013 to $22 per barrel of oil equivalent. Similarly, production costs, which include production taxes, transportation costs, and production-related general and administrative expenses, also increased at more than 14% CAGR between 2009 and 2013 to $19.60 per BOE. We expect this trend to continue in the long run, primarily because most of the growth in future crude oil production is expected to come from higher marginal cost areas like tight oil in the U.S., oil sands in Canada, and pre-salt reserves in Brazil. Therefore, lower crude oil prices are expected to weigh significantly on exploration and production EBITDA margins (http://www.ey.com/Publication/vwLUAssets/EY-global-oil-and-gas-reserves-study/%24FILE/EY-global-oil-and-gas-reserves-study.pdf).

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Lower Capital Expenditures

Oil and gas companies capitalize finding and development costs in order to distribute these costs over the lifetime of a drilled well or a raised platform. These costs are as high as 50-70% of operating revenues for the large independent companies we cover. ConocoPhillips (https://www.trefis.com/company?hm=COP.trefis), the largest independent exploration and production company in the U.S. by production, recently announced its 2015 capital expenditure plan. The company revealed that it plans to cut capital spending by a fifth next year due to the recent decline in oil prices. The company plans to spend around $3 billion less next year on leasing rigs, floating oil platforms, and installing pipelines, compared to this year. It plans to defer spending on some of the less developed unconventional plays in North America, which include the Montney and Duvernay fields in Canada, the Permian Basin in Texas, and the Niobrara shale field, which extends over Colorado, Wyoming, Nebraska, and Kansas. We expect similar capital expenditure cuts to be announced by most of the independent oil producers in the U.S. including Anadarko Petroleum (https://www.trefis.com/company?hm=APC.trefis) and EOG Resources (https://www.trefis.com/company?hm=EOG.trefis).

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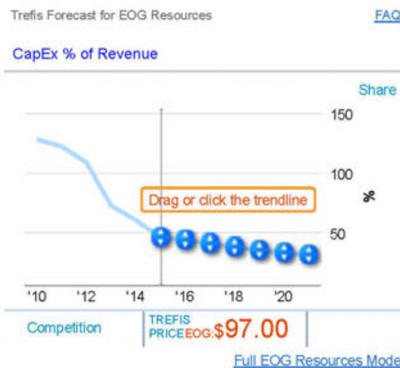

Lower capital expenditure essentially means lower investment in future production growth, which is what upstream companies do in a commodity down cycle. However, in the longer-run, once crude oil prices bottom out, we expect capital expenditures to increase in absolute terms because of the continued rise in finding and development costs and the pursuit of higher production growth by exploration and production companies. For example, we

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currently expect EOG Resources' net annual capital expenditures to decrease from $7.8 billion this year to around $6.5 billion by 2017-2018, and thereafter increase to about $7.5 billion by 2021.

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