

What next for the oil & gas sectors across Europe?



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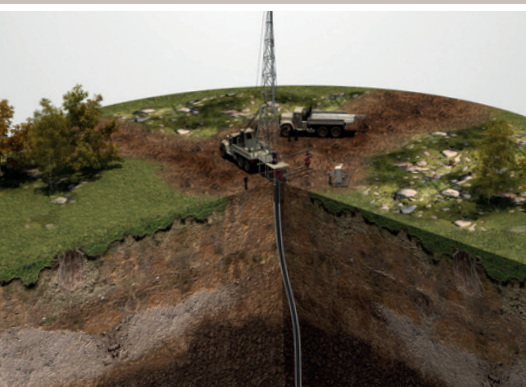


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The outlook for the oil and gas market in Europe appears challenging, with the changes that are underway as to how resources are extracted driving significant uncertainty. Here we take a look at some of the issues through the production process and how those companies that have historically been at the centre of these sectors are responding.

Upstream



Exploration



Production



Transportation

Upstream is becoming more volatile as the majors exit

As a result of factors such as increasing costs of extraction in the North Sea depressing margins, the majors have been exiting exploration and production in Europe, leading to a huge rise in the number of independents. These independents generally lack the vertical integration and big balance sheets of the majors, making them susceptible to short term declines in oil and gas prices. Although prices are presently high, they may not remain so, particularly given the potential knock-on effects of the shale gas boom in America. The independents are also vulnerable if their huge expenditure on capex fails to generate an adequate return quickly enough – as shown by the recent administration of Vostok Energy Plc. The solution in that instance was to sell the operating assets to an investor with the ability to invest appropriately.

The downstream oil market has up to 30% too much capacity

Oil refineries are at the heart of the European oil market, but they are struggling because there is too much capacity. Many refineries are under threat of closure as they are too small, too old and not well geared to the modern preference for diesel, meaning that they have an uncompetitive cost profile compared with the new refineries being built in Asia. European refinery costs are also adversely affected by increasing EU regulations on environmental emissions and on the bio content and contaminant limits in transport fuels.

Demand is being depressed by high prices and continuing difficult economic conditions in some areas of Europe. Refining margins are low as a result of these market dynamics and a large number of refiners are making losses. This makes oil refinery closures inevitable unless refiners restructure or strategically reposition their assets. One option is to convert refineries into storage and distribution terminals.

The European gas market is facing strong headwinds...

Gas is expensive in Europe for a number of reasons, including the growing dependence on imported fuel and because alternatives to imported gas, such as European shale gas and biomass are at a relatively early stage of development. Overcapacity may eventually bring a sharp price drop, but not just yet.

On the positive side, a number of trends indicate better times ahead for the gas sector, including uncertainty over the future of nuclear power, the economic validity of renewable energy and the retirement of coal fleets. However, this situation is not expected to change imminently.

Downstream



Oil Refining & Gas Processing



Distribution, Sales & Marketing

but downstream gas assets could be seen as an attractive investment opportunity given the potential for a rebound

At present, gas plants in Europe are generally 'out of the money', with approximately 90% of current capacity not generating sufficient profits to cover related financing costs. It is possible that c.20% of Europe's gas processing capacity could be shut down within the next three years before a rebound occurs. Factors such as gas moving up the merit order and gas price convergence mean that gas plants might be seen as attractive investment propositions, particularly after appropriate restructuring.

Companies providing support services to downstream operations could be vulnerable in the short term

Refineries, gas processing plants and power generation assets are mostly owned by large international groups with sufficient financial resources to be able to take a long-term view of the European market. However, in the interim they are under investor pressure to cut costs, perhaps by mothballing certain assets. For those that will never be financially viable, a decision about whether to exit will need to be made as early as possible to mitigate losses and value diminution.

Companies providing support services downstream often have much smaller balance sheets and hence will find it difficult to survive any downturn that lasts for a sustained period. Unless they are able to adapt their operating models, the best option may be to integrate vertically with others in the supply chain.

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