

# Transaction Trends

Joint ventures and divestitures:  
focus on oil and gas

## Strategic planning considerations

# Transactions pick up, but oil and gas sector faces more regulation and competition

Uncertainty, risk, regulation, vigilance – these are some of the watchwords for the energy industry in the wake of the nuclear crisis in Japan, unrest in the Middle East, the Gulf of Mexico oil spill and the worldwide call for clean technologies. In the coming months, oil and gas companies are expected to face: increased regulatory safety measures and their cost impact; the potential shifting of investment away from the highest-cost offshore areas; industry consolidation, including mergers, acquisitions and divestments; an increase in joint ventures to mitigate risk, liability and increased insurance levels; and an accelerated transition from oil and gas to other energy sources.

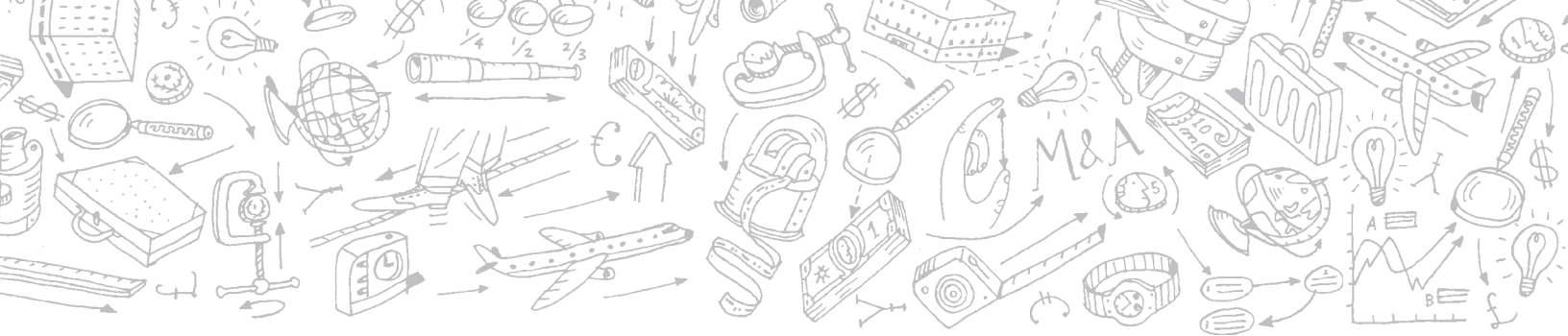
**Last year's vigorous deal activity will continue in 2011.** Oil and gas merger and acquisition activity was strong in 2010, with credit markets opening, big oil flexing its financial strength and BP exceeding its spill-related divestiture targets. Total global industry transaction value topped US\$266 billion, up 33% from 2009; the number of deals went up 13%; and deal value rose strongly in each of the four industry segments, with total upstream transaction value reaching a record high. Transaction activity is expected to be similarly brisk this year.

**Upstream joint ventures take off.** Independent players in the capital-intensive gas industry began partnering more vigorously with majors as the recession deepened in 2008. "The last 18 months saw a huge proliferation of joint ventures," notes Deborah

Byers, Ernst & Young LLP's Americas Oil & Gas Tax Leader (see chart on pages 4-5). "Joint ventures are going to be extremely active in the next year as well. There will be a lot of competition for projects to come online, but not all are going to survive. Some projects will not move forward, and those that do may not necessarily be the biggest ones."

**Consolidations loom downstream.** In the wake of the oil spill, the prospect of greater regulation and oversight will slow down the process for getting permits for drilling, leaving many smaller players with fewer options to generate revenue. They may be forced to merge with bigger players or drill in other locations. Several companies that built liquefied natural gas (LNG) receiving terminals – such as Cheniere Energy – are finding themselves with

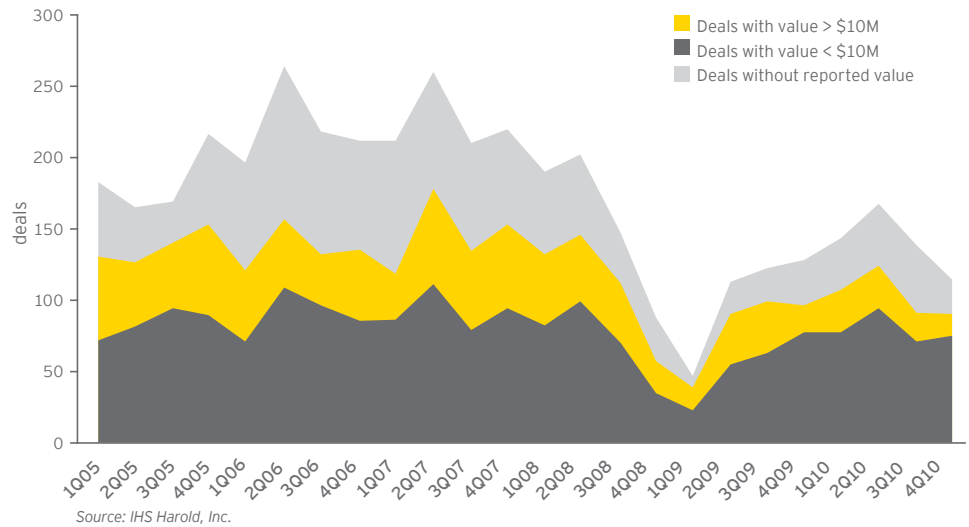




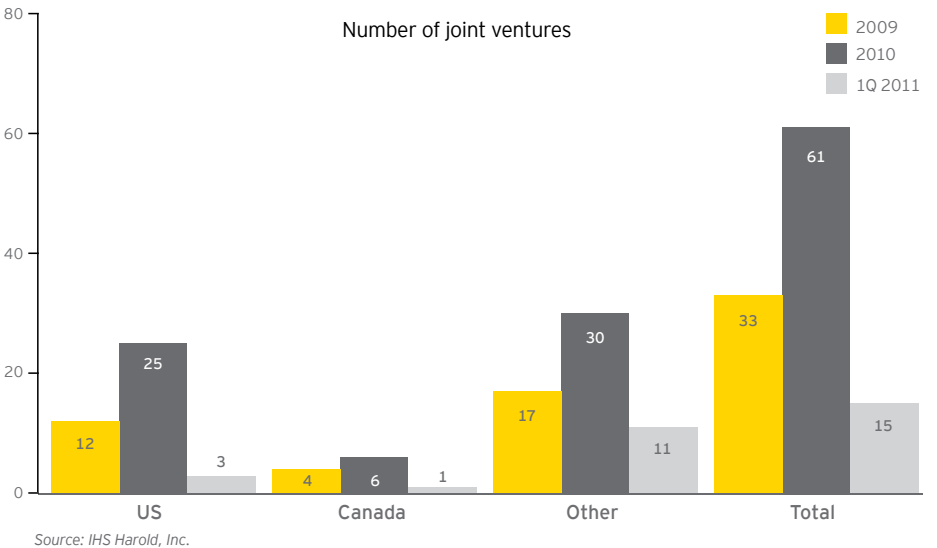
excess capacity and are evaluating export markets, partnerships and other strategic options. Chevron and its partners, which include ExxonMobil and Royal Dutch Shell, are expanding their Gorgon LNG project in Australia, capitalizing on growing Asian demand. The discovery of major oil deposits in Brazil and shale gas in Canada will trigger more industry shakeouts.

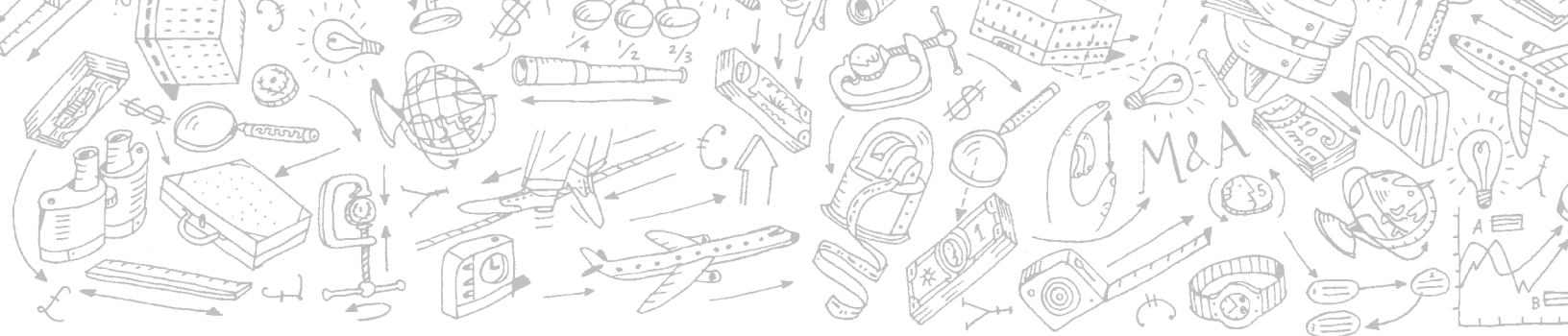
**Oil shale activity increases.** The past 18 months have seen a significant ramp-up in oil companies' planned investments in unconventional oil plays. For oil extraction, majors such as ConocoPhillips, Marathon Oil and Hess, as well as independents like EOG Resources, expect to use the cost-effective hydraulic fracturing (fracking) methods that have been successful in boosting natural gas production. Producers will exploit plays such as the liquids-rich Eagle Ford in Texas; North Dakota's Bakken Shale, which extends into Montana and across the Canadian border into Saskatchewan; and an emerging shale play called Niobrara, which straddles Colorado and Wyoming. Norway's Statoil and Canada's Talisman have formed a joint venture to develop Eagle Ford acreage. In March 2011, Estonia's state power firm, Eesti Energia, bought a major US oil shale player, Utah's Oil Shale Exploration Company, with the intent to acquire a strategic partner in the development phase. The main factor likely to inhibit the projected growth in shale gas production is new environmental legislation. In particular, regulators and policy-makers are concerned about possible threats to

**North American oil and gas M&A transactions (excludes Global Diversified transactions)**



**Joint ventures surge in 2010**





local water supplies and public health as a result of hydraulic fracturing, and the U.S. Environmental Protection Agency is studying its impact.

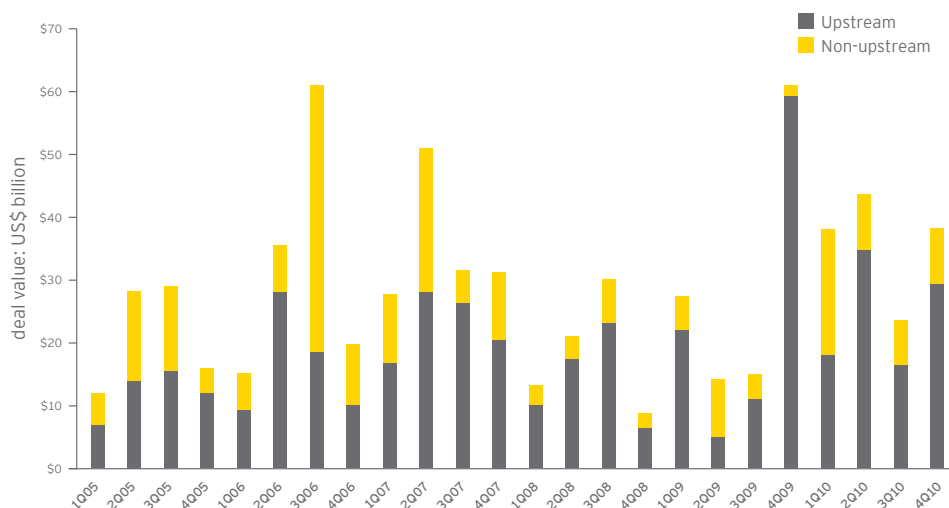
**The influx of Asian companies continues.**

The past year saw a dramatic uptick in the number of Asian companies investing in North American energy projects. “What we are seeing are new entrants that are not your classic international oil companies – they are companies from Asia that may not have the experience or the expertise, but they are trying to gain that expertise and maybe export it somewhere else,” says Byers. In 2010, public and national players from countries such as China, India and South Korea invested a total of US\$17 billion in energy ventures – the majority of them joint ventures – in the US and Canada.

**International oil companies (IOCs) bump up investment in China.**

Deal values for most of the big IOCs are not reported, but super majors such as BP, Shell and ExxonMobil all have refining and/or petrochemical joint venture (JV) projects under way, and Saudi Aramco has just announced another refining JV. Shell has had some recent success with shale gas exploration in China and expects to move forward in a big way. Several of the other IOCs, notably ConocoPhillips, are becoming increasingly involved with exploration and production in offshore China.

**North American oil and gas M&A transactions (excludes Global Diversified transactions)**



Source: IHS Harold, Inc.

**Asset churn increases in Russia and the former Soviet Union.** Deal activity in these regions appears vigorous but is largely opaque; transactions are mostly internal, although Chinese and Indian companies have made some investments. There is, however, great demand for new exploration projects in Russia to secure oil and gas production levels in the period after 2025. Until recently, IOCs were not admitted to develop any new substantial field, but in early 2011, Russian oil company Rosneft announced plans to set up JVs with Chevron, BP and ExxonMobil to develop fields in the Arctic and Black Sea regions.

**The transition to alternative energy speeds up.** Rising global demand for energy has led both governments and businesses to seek alternative sources of energy and key commodities. But as renewable energy is still expensive, fossil fuels – such as oil and coal – will remain a vital part of the energy mix for some time to come. Construction of nuclear power plants is likely to slow or be put on hold in the wake of the nuclear crisis in Japan. Natural gas, a cleaner-burning fossil fuel, is expected to grow more important, serving as a bridge to a cleantech-based economy. ▲

# Market alerts

## The new JVs: a key growth strategy

The oil and gas sector is no stranger to joint ventures. Today's JVs, however, come in so many shapes and sizes that it can be difficult to decide on the optimal arrangement. For example, private equity partners have come into play – several funds are dedicated to the oil and gas industry – small independents are partnering with one or many majors, and public and national oil companies from all over the world are entering the market. All offer exciting combinations of resources, assets, capital, expertise and labor. The right JV can optimize these to shape a dynamic growth strategy. Here are some important factors to consider:



- ▶ **Determine your objectives.** Pinpoint exactly what you want to accomplish. Is your company growing? Is it divesting? Is it trying to gain new technology? Enter a new market? Which partner(s) can best help you achieve these goals?
- ▶ **Make sure you can trust your JV partner(s).** JVs are often complex, long-term arrangements. Trust, therefore, is critical to the success of the relationship. The early signs of whether your company and its partners are compatible will be evident during the negotiation phase.
- ▶ **Don't overlook the cultural aspects of a JV.** Culture isn't restricted to countries. Different companies can also clash when they come together. For example, a super major may want to set up a JV with a much smaller company or a PE firm. "Each is going to have different processes for internal control and reporting requirements, and those are the kinds of things you need to vet so that you are aligned going forward," says Deborah Byers, Ernst & Young LLP's Americas Oil & Gas Tax Leader.
- ▶ **Figure out your exit strategy.** The oil and sector is an unpredictable

37%

of oil and gas companies in the April 2011 Ernst & Young Global Capital Confidence Barometer are seriously considering a JV in the next 12 months.

environment, so it is important for JV partners to be prepared with an exit strategy right from the start. "If you are a PE investor, maybe you want to back off from your investment in a gradual way," says Byers. "Or maybe you want to do an IPO, and if that happens, how do you participate in it if there is a big value creation? All of those things need to be hammered out so that you don't have controversy along the way or at the exit."

- ▶ **Establish responsibility for governance and oversight.** To control risk and exposure, it is essential to clarify which of the JV partners will operate the properties, who has responsibility for what, whether all JV partners are transparent in reporting and providing information, and how rewards and liabilities are shared.

- ▶ **Arrange exclusive rights up front. It is possible,** for example, that development of a resource yields discoveries in adjacent areas that are not included in the properties originally defined in the JV. Anticipate such events and include any access rights in your contractual arrangement.
- ▶ **Do your due diligence.** Treat a JV as you would a divestiture or a spin-off. It is advisable to conduct a liquidity analysis on your JV partner, research the management team and make sure you have access to the information you need for your own financial and tax reporting. ▲

## New laws will affect oil and gas sector

**Proposed federal legislation may have a negative impact on the industry.** The US government's proposed budget for fiscal year 2012 includes the proposed repeal of certain federal income tax incentives currently available to certain oil and gas companies. On 14 February 2011, the Obama Administration released its Proposed Budget, which incorporated a number of provisions that, if enacted, would significantly affect the oil and gas industry. In part, these provisions would:

- ▶ repeal expensing of intangible drilling and development costs
- ▶ repeal percentage depletion for oil and natural gas wells
- ▶ repeal the domestic manufacturing deduction for oil and natural gas companies
- ▶ increase the geological and geophysical amortization period for independent producers to seven years
- ▶ repeal the exception to passive loss limitations for working interests in oil and natural gas properties

In addition to provisions that would directly affect the oil and gas industry, the Proposed Budget includes certain provisions that, if enacted or eliminated, may have a negative impact on the financial condition and results of the operations of certain oil and gas companies, including, in part, the reinstatement of the Superfund taxes, repeal of the last-in/first-out method of accounting for inventories, modification of the rules for dual-capacity taxpayers and certain other international reform measures.

**New bonus depreciation provisions aim to spur growth by encouraging capital investment.** On 17 December 2010, President Obama signed into law H.R. 4853, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "Act"). Although affecting all industries, the Act generally extends and modifies the bonus depreciation provision under Section 168(k) of the Internal Revenue Code of 1986, as amended (the "Code"), and provides for the temporary 100% expensing of certain qualifying capital expenditures. These provisions have – and

will continue to have – a significant effect on the capital-intensive oil and gas industry. The Act adds Section 168(k)(5) to the Code, under which certain taxpayers may qualify for a first-year, bonus depreciation percentage of 100% – effectively allowing immediate expensing – with respect to qualified property acquired by the taxpayer after 8 September 2010 and before 1 January 2012, and which is placed in service by the taxpayer before 1 January 2012 (1 January 2013 in the case of certain property having longer production periods and certain aircraft). The Act also extended the application of the 50% bonus depreciation allowance for certain properties. It is expected that the cost recovery incentives relating to bonus depreciation should accelerate plant and equipment purchases in 2011 to take advantage of the 100% first-year bonus depreciation allowance. On 29 March 2011, the Internal Revenue Service issued guidance regarding the application of the 100% bonus depreciation provision. ▲

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