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Global Oil & Gas Offshore PF Outlook 2011: A year after BP's disaster

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Houston (IJ Online) – Twelve months after the Deepwater Horizon rig at the Macondo oil well in Gulf of Mexico exploded and oil spewed into the ocean for 87 days until it was sealed by BP on July 15, 2010, the industry, offshore project financiers, sponsors and governments around the world have gone through a period of reflection. Exactly a year to the infamous date of April 20, 2010 one point to emerge was that a perceived global dip in offshore projects has not materialised. For some this may be startling, yet others feel it is not entirely unexpected.

Apart from the US, the wider market elsewhere withstood the bad press, a vocal court of public opinion and legislative probing to a great extent. In fact, as offshore projects in the US face restrictions on fresh prospection zones and delays in drilling permits being awarded, the rest of the world has not taken a step back.

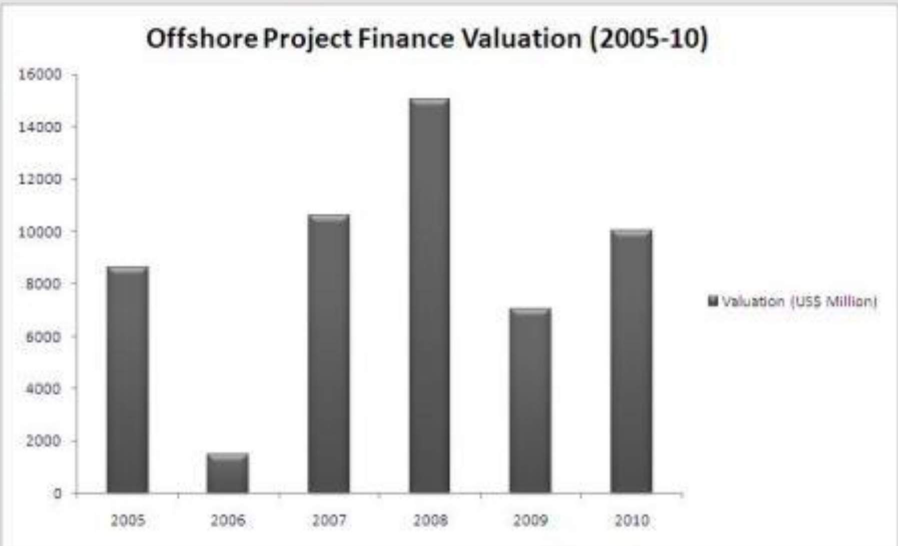
File photo of BP's containment drive at Macondo site, Gulf of Mexico, USA © BP Plc

If project finance data for offshore oil & gas projects is taken in to account, IJ's figures suggest that finance volumes actually rose by US$3.01 billion or 42.8 per cent year-over-year while the number of projects coming onstream also rose nominally.

However, as discussed later on in this report, the diligence time load has magnified considerably – both in the US and globally, given the understandable anxiety related to offshore projects and the need to ensure that stringent compliance standards are met in wake of Macondo.

IJ data, Brazilian sunshine & public opinion

In global terms, IJ's collated project finance data and empirical industry evidence suggests that both offshore drilling activity and the project finance market for offshore oil & gas projects actually rose. Charting offshore projects for which the debt markets were approached in 2010, a total project valuation of US$10.02 billion was noted with 15 transactions reaching financial close. The valuation is up by 42.8 per cent from 2009 wherein 14 transactions valued at US$7.01 billion were recorded.



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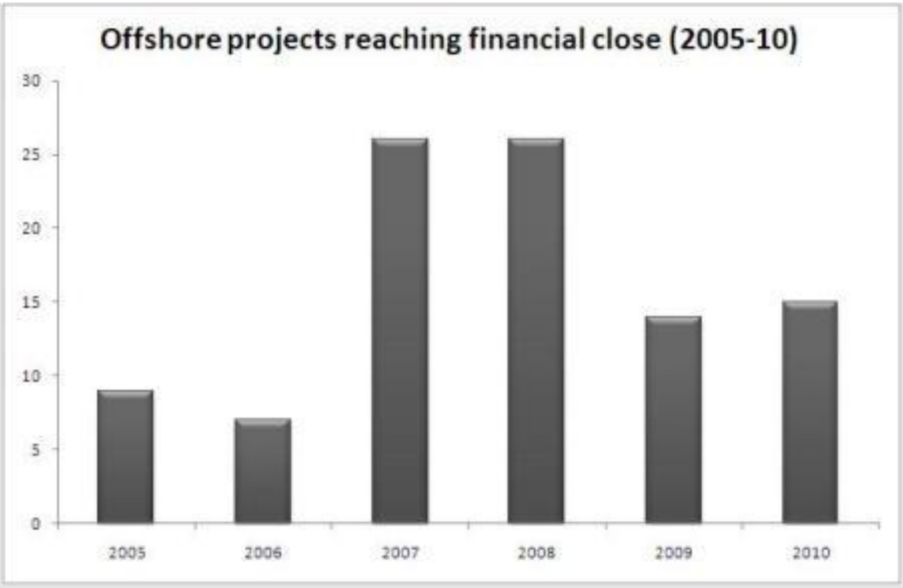
Using the present IJ data series, which commenced in 2005, hitherto 2008 remains the bumper year for the last half-decade with a valuation of US$15.05 billion and 26 transactions reaching financial close. If anything, IJ analysts believe the financial crisis did more harm to the cause of offshore drilling and finance procurement than the BP fiasco.

For all intents and purposes, the sun is shining on the Brazilian offshore industry. As legislative, socio-political factors and a general nervousness hampers US offshore, albeit temporarily, Brazil marches on regardless. Over the last three years, sponsors of offshore projects in the country have been consistent in approaching the debt markets and bringing 3-5 projects per annum to financial close. The year 2010, was a particularly good one for Brazil with five projects reaching financial close.



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There are no surprises that Petrobras – the country national oil champion – is at the heart of these offshore projects. IJ analysts' research suggests that overall (including debt and equity financed projects) Petrobras currently accounts for 21 per cent of all offshore projects taking off the ground globally as a consortium partner.

If Brazilian ambitions need any more flagging-up – the country, according to a government spokesperson, is at an advanced stage of reaching a decision on the purchase of high volume deep-sea drill ships and allied floating platform equipment. Each of these offshore beasts would cost US$3.5 billion at the current exchange rate. Taking things into perspective, only 77 of these are in operation or post-commissioning stage at the moment around the world. The Brazilians are looking to order over 40.

Public opinion or should we say opposition to offshore drilling certainly varies from country to country. Most governments are withstanding pressures and permitting drilling. IJ recorded offshore projects in countries as diverse as Mexico, Vietnam, East Timor, Equatorial Guinea, Egypt and Nigeria rubbing shoulders with UK, US and Brazil in bringing project financing to a close over 2010.

On the other hand, anecdotal evidence IJ has suggests it would take a legislator with some guts to allow fresh offshore drilling in the US state of California and the Canadian province of British Columbia, the latter being the birthplace of Greenpeace. In both jurisdictions, the court of public opinion is totally against offshore and regional politicians are toeing the line according to our intel.

There are concerns in Europe as well about offshore drilling, but as of now the British, Dutch and Norwegian governments – the three major players for offshore – appear to be holding firm. Criticism has been levelled at Brazil, but the latter feels irked.

A government spokesperson notes, "Everything is effectively monitored, whether it is the overseeing of how and on what terms Brazilian prospectors approach debt finance to how drilling permits are granted. Just because we are keen on tapping our hydrocarbon resources does not imply that we have granted people a licence to puncture our continental shelf at random and without oversight."

Jose Valera, Houston-based partner at Mayer Brown LLP and an expert on Latin American energy jurisprudence feels the Brazilians have a point.

"For instance, the EU does not have indigenous hydrocarbon resources to satisfy all its requirements and is an importer of fuels. So it has a greater incentive from an economic perspective to come up with an alternative and promote conservation. Brazil is not necessarily in that camp. It has found a resource which the Europeans, or shall we say most European nations lack. It's a huge resource and they are going to exploit it based on the global supply and demand permutations," he notes further.

Brazilian Projects in 2010	Date of financial close	Valuation (US$m)
Sevan Driller II	30-Apr-10	525.00
Tupi FPSO Project	03-May-10	800.00
OSX-1 FPSO	09-Sep-10	551.00
ODN I and ODN II Deepwater Drill Ships	28-Sep-10	1,312.00
Odebrecht Drilling Norbe VIII & Norbe IX refi	18-Nov-10	1,500.00

Brazilian offshore PF deals in 2010 © Infrastructure Journal, April 2011 (Please click to enlarge)

"Quite frankly, they see an opportunity to become a major hydrocarbon exporter and would not be lectured to. As long as Brazil administers its offshore drilling programme well, we are talking different market realities – the commentary hence varies in both locations," he concludes.

Some feel the narrative should now focus on the merits or otherwise of particular offshore projects rather than a blanket damning or promoting of an entire industry. "At the present moment in time, sometimes you get the impression that the political discourse is focussing on the divisions - whether you are for or against offshore. This is counterproductive. We need the resource to run the infrastructure that we have, to power our lifestyle and we cannot shut this off – we are talking jobs, displacement – any number of things," says Brian Pyra, Calgary-based partner at Deloitte (Canada).

Pyra along with many industry professionals believes a balance of legislation and regulation to prevent accidents like Macondo from occurring is needed for sure. No amount of regulation can prevent an accident, but it can reduce the chances or odds to a minimum.

Of debt pricing for offshore and going "Ultra-deep"

One thing is for sure, the cost associated with offshore projects is going to rise. The industry believes compliance cost is more likely to be borne by the project sponsor and absorbed by the equity that is put up rather than it reflecting in the rate of long term loans. Indeed, IJ's data suggests that debt pricing for offshore projects did fluctuate over the last two years but that it was part of a wider industry trend either side of the financial crisis. The Macondo incident did not have a much of an impact and loan pricing is now back to pre-crisis levels.

Top five offshore projects in 2010						
Project	Country	Date of financial close	Valuation	Debt	Equity	Multilateral & Govt Support
Pacific Drilling Vessels Financing	United States	06-Dec-10	3,042.00	1,800.00	1,242.00	800.00
Odebrecht Drilling Norbe VIII & Norbe IX refi	Brazil	18-Nov-10	1,500.00	1,500.00	0.00	0.00
ODN I and ODN II Deepwater Drill Ships	Brazil	28-Sep-10	1,312.00	890.00	262.00	160.00
Tupi FPSO Project	Brazil	03-May-10	800.00	800.00	0.00	0.00
FPSO Aseng	Equatorial Guinea	14-Dec-10	765.00	400.00	365.00	0.00

Top five offshore PF deals in 2010 © Infrastructure Journal, April 2011 (Please click to enlarge)

Debt deals with LIBOR+175bps to 250bps for term loans for oil & gas offshore projects have been noted; this is below average 2009-levels. The most expensive deal on record for an offshore project for 2010 saw a pricing of LIBOR+350bps on a five year term loan. Competitive pricing is back and it can be attributed to better market liquidity more than anything else. Draw down dates have not altered either coming in at typically 12 months or less.

John Mauel, Houston-based partner at Pillsbury Winthrop Shaw Pittman LLP feels market sentiment about the burden of regulatory compliance cost being more pronounced on the project sponsors' side has a solid basis.

"This would reflect in the equity the sponsor puts up for the project prior to approaching the debt markets. Rising costs may be attributed to new well design, casing and cementing standards, workplace safety plan requirements, permit delays, uncertainty in terms of getting project approval and time load for the due diligence which has increased post-Macondo," he adds.

Given the magnitude of the BP incident, 12 months hence people's attention is still focussed on energy safety; the ripple effect is still being felt in political circles, Mauel opines.

"Quite frankly, it really cannot be mitigated cost-wise, especially given the current climate. So the financier may price in the risk in the loan rate while the sponsor also has to make additional allocation to the equity that is put up to meet such costs," he concludes.

Pyra of Deloitte believes the difficulty arrives in putting some sort of an average figure on the sponsors' regulatory compliance burden. "Not every project is the same, if you are considering a multimillion drilling project and it gets delayed by a year owing to regulatory hurdles then that is a significant delay. This places strain on the investment capital put up by the sponsor."

The increase could be a relatively small percentage of the overall costs, depending how much time is taken up by regulatory approval in different global jurisdictions. "However, if we are looking at a painfully long approval process then the project sponsor and his accountants would need to constantly evaluate the situation. This is the challenge for offshore post Macondo," he concludes.

Industry-wide implications aside, it is worth noting the creditworthiness as project sponsors of those involved in the Macondo incident. Ratings agency Moody's believes credit implications for the five companies involved remain uncertain a year after the accident and legal clarity will probably not emerge for at least another year.

Three of the five companies involved – BP, Anadarko Petroleum and Transocean – could face severe monetary penalties, while Halliburton and Cameron International look less likely to suffer long term financial impact from the accident.

"Authorities have yet to determine and apportion blame or impose legal and financial penalties. Our analysis suggests that the accident may result in financial penalties of between US$40 and US$60 billion, which includes US$20 billion that BP will place in escrow by 2013," says Steven Wood, MD for Oil & Gas, at Moody's.

File photo of Discover Enterprise 1 flaring at Macondo site, Gulf of Mexico, USA © BP Plc

A trial set to begin in February 2012 will start off by clarifying the liabilities for all parties, which will offer a strong clue about how Macondo will affect them from a credit perspective. BP holds a 65 per cent interest in Macondo.

IJ analysts believe Transocean – which owned the Deepwater Horizon rig – is the biggest puzzle from a project finance standpoint. Prior to the incident, it frequently tapped the debt markets but has not done so for a while now. Moody's, at the time of going to press, maintains a negative outlook on Transocean's current Baa3 rating. This makes borrowing for Transocean all that more expensive, but not impossible and perhaps explains its absence from the debt markets.

Furthermore, BP is suing Transocean for US$40 billion in damages blaming the safety systems on the Deepwater Horizon rig. At a US federal court in New Orleans on April 20, 2011, BP said Transocean and Cameron International, the Houston-based company that supplied the blowout preventer (BOP), should help it pay for billions of dollars in liabilities resulting from the spill.

"The Deepwater Horizon BOP was unreasonably dangerous, and has caused and continues to cause harm, loss, injuries, and damages to BP (and others) stemming from the blowout of Macondo well," its legal papers note.

While the US watches this lawsuit nervously, Brazilian project sponsors and especially Petrobras, have no such worries or for that matter any hang-up either as their offshore programme proceeds with confidence. They are in "ultra-deepwater" mode.

Depths vary, but if we are talking ultra-deepwater drilling – then by average estimates one can hit the ocean floor at 7,000 feet, followed by 9800 feet of rock layer, and another 7,000 feet of salt layer before the drillbit hits what can be described as the fruits of deep-sea oil.

While the technology is there and improving, ultra-deepwater drilling faces three times more water pressure than conventional offshore drilling and salt corrosion. Yet, according to collated data[1] the deep drilling rig count has increased nearly 32 per cent year-over-year from February 2010 to February 2011. If offshore was somehow being clobbered, there seems to be no empirical evidence, only a fair bit of risk realisation.

Risk realisation, diligence time load and compliance costs

Both legal and financial advisers feel the Macondo incident delivered a kick in the teeth, but one which offshore project sponsors perhaps needed. Valera of Mayer Brown feels the risk was underappreciated and underpriced before this incident, so the compliance costs will go up but not because the 'risk' itself has gone up.

"Risk was always there when it comes to offshore drilling; the Macondo incident has brought the risk 'home' to sponsors and financiers. The ongoing assumption that major accidents could mostly be averted has now been replaced by owners demanding that even the most stringent of compliance standards be taken care of. This is not going to go away and will be priced in getting offshore projects off the ground," he adds.

US criticism of BP was to a significant extent centred on its failure to require provision of a remote control blowout prevention device. This is heavily regulated and is a requirement in the North Sea – both in the British and Norwegian sectors - where compliance was tightened after the Piper Alpha tragedy (July 1988). Brazil employs similar standards since 1997, according to a government spokesperson.

The US Bureau of Ocean Energy Management, Regulation and Enforcement (BOEMRE) – the successor to the much maligned Minerals Management Service (MMS) – is finally working on yet more stringent safeguards. Time load is the key again here as there is legal pressure both on it and the US Government to issue fresh drilling permits.

US industry's answer to government pressure is the rollout of a Marine Well Containment System capable of capturing 60,000 barrels of oil a day in water depths to 8,000 feet, being fronted by an ExxonMobil-led consortium. A containment device has now become a pre-requisite in the Gulf to obtain a drilling permit in deep waters.

Valera believes not everyone would be able to afford it and smaller project sponsors would find the Gulf of Mexico too expensive to operate in. "Proof is that since the moratorium was lifted in Oct, 2010 – whatever permits have been issued, have been to large oil companies. Smaller players – at present – will be hard pressed to comply with the existing regime. Are we looking at potential delays in projects coming onstream (in the US) – most certainly – at least until the containment system becomes relatively cheaper and within reach of smaller players," he adds.

Costs aside, there is clear evidence of an increase in the diligence time load, which simply put is the duration of the legal compliance paperwork for bringing offshore projects to the stage where finance can be sought either via the debt markets or equity finance whichever the case may be.

Apart from the US, after Macondo Australia, Brazil, Canada, China, Greenland (Denmark), Norway, Russia and the UK were first to reassess their industry standards. However, away from the US, regulatory aspects did not alter by much elsewhere.

Nonetheless anecdotal evidence from these countries as well as the US suggests diligence time load has increased by a minimum of 3 to 6 months from what it was prior to April 20, 2010. For the US, this statement excludes the period between the tragedy and President Barack Obama's ultimate lifting of the moratorium on drilling on Oct 12, 2010 – before which there was a total freeze on activity post-Macondo.

The industry as a whole needs to hold firm, bear the additional oversight and get used to increased scrutiny according to Dallas Parker, Houston-based partner at Mayer Brown LLP and head of their oil & gas practice.

"The will be more safety audits, more checks and rigorous inspections. There will be an increase in the professional time load over which a legal adviser sets the clients' permit paperwork in order, and conducts the due diligence. Collectively taken, all this will add not just to the cost of getting the projects off the ground and but also to the costs of the preparatory phase before an actual drilling permit is applied for in the Gulf," he says.

"Do not forget, we are talking about drilling depths of 5,000 feet and above, and the depth is constantly rising. Its prudent to point out that post-Macondo this is not just a US problem; offshore drilling is not just crucial for the petroleum security of the US but other nations as well. Brazilian offshore fields which are up to 200 miles off the coastline are a prime example," he adds further.

Parker and his industry peers have a rather blunt assessment about the current state of flux the market is in whichever way you look at it. "An increased time load translates to costs, or simply put time is money for project sponsors. A layer of legislation adds to a layer of compliance cost. I don't think anyone knows right now what that time load might be (in the US)...or can put a definite figure on it," Parker concludes.

The "Golden Triangle", politics, finance and where from here?

Barely nine days after President Obama lifted the offshore drilling moratorium, oil giant Chevron announced plans to drill new oil & gas wells in the Gulf of Mexico. A spokesperson for Chevron says it would initially invest US$7.5 billion in exploring the Jack and St Malo fields, 450km south of New Orleans, in water depths of 2,100 metres (6,890 feet approx).

First production is expected in 2014, and Chevron expects the facility to have a capacity of 170,000 barrels of oil and 42.5 million cubic feet of natural gas per day. It estimates the fields hold total recoverable resources equivalent to 500 million barrels of oil and hopes to tap hydrocarbons with the "robust safety standards." This is all it took – nine days.

Andrew Rig, in the UK sector of the North Sea © BP Plc

It is worth noting that published data[2], most notably that of the US government indicates that at present there are 39 known deepwater oil fields, 12 of which are located in its front yard – the Gulf of Mexico. More crucially from a global standpoint 15 are located off the coast of Brazil, 10 off the West African coastline and both Indian and Indonesian external affairs ministries have confirmed to IJ that they believe they have one apiece.

Most deepwater oil has indeed been found in the Gulf of Mexico, Brazilian and West African waters and the analysts community has a name of for it which oilmen love – "the Golden triangle" (not to be confused with the illicit opium producing area in Southeast Asia). The Tupi and Jupiter fields off the Brazilian coast are two of the largest deepwater reserves discovered in recent years followed by offshore activity in Angola and Nigeria. Rewards aside, the question of risk does hound investors.

Todd Culwell, Houston-based partner at Pillsbury Winthrop Shaw Pittman LLP notes, "Post-Macondo, the 'what-if' risk sentiment affects the investor or project sponsor's psyche even if we are talking about drilling in shallow waters. The question for offshore project financiers as a whole, and not just deepwater drillers, is not where do we go from here, but how do we go forward from here when it comes to compliance costs? These costs are rising and it is something project sponsors will have to contend with – globally."

Evidence suggests financiers, oil majors or project sponsors would not be giving up any time soon. IJ analysts believe offshore project finance market would continue its bounce back from pre-financial crisis levels. While projects will take longer to come to the market post-Macondo, the sector fundamentals, availability of finance and demand projections for crude oil appear healthy for the next five years. In fact, we expect the years 2012-2015 to be crucial for offshore and maintain a positive outlook for offshore project finance.

What spooks the market in general and US market in particular is some sort of draconian, rushed up legislative framework that stunts investment. Parker of Mayer Brown feels, that in looking at legislative safeguards after Macondo, the tone of the senators and congressmen from US oil producing states was milder whereas those from non-oil producing states called for stronger legislation.

"Either way, nobody suggested a light touch approach any more given the ecological complications of an oil spill. A lot of the population does not understand some of the process involved in offshore drilling – so a greater understanding needs to be promoted. The industry and indeed the wider oil markets can withstand regulation – it is a fact of life. What they cannot handle is some sort of a draconian knee-jerk reaction," he concludes.

So far this has not happened – either in American corridors of power or elsewhere. Oversight has increased globally which is welcomed by both legal and financial advisers alike but not by small to mid-cap offshore project sponsors, who could very well be priced out of the market in the medium term.

Finally, IJ analysts do not expect BP to give up on the US as a project sponsor. For the next 10 years at the very least, the US will remain the world's largest market for consumption of gasoline. As such BP will never pull out of such a lucrative market. In fact credible evidence suggests it will reapply for offshore permits in a fresh round of prospection, though no one knows how US regulators would respond.

Additionally we believe BP's recent refining and marketing (R&M) infrastructure asset sales in North America would most likely have happened even if the Macondo tragedy had not occurred. It is not the only IOC selling R&M assets and we noted in our refineries infrastructure report that such a trend has nothing to do with the tragedy in the Gulf of Mexico[3].

As Parker of Mayer Brown notes, "IOCs move away from the integration model has more to do with economics than events in the Gulf of Mexico. This move away from the refining and marketing aspects of the business in favour of exploration and production (E&P) has more to do both with rewards and returns which evidence suggests are higher on the E&P side of things (especially given that non-OECD consumption is rising). However the integration model is not dead, everything moves in cycles."

IJ believes this refocusing actually started around the early-1990s but there is some evidence that Macondo perhaps accelerated the pace of R&M infrastructure asset divestment by the oil majors. Offshore prospection for hydrocarbons sits happily with the "high risk, high reward" model of E&P infrastructure projects.

Along with the wider industry, we conclude that the "high risk" component after Macondo has a higher visibility and reflects more in project financiers psyche. However, an even higher reward would maintain a steady pipeline of offshore projects coming onstream given the current and projected price of crude oil.

With additional reporting by the author from San Francisco, Vancouver, Calgary and London.

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NOTES:

[1] Average percentage of IJ PF data for closed financing, Baker-Hughes and Smith Bits

[2] US EIA, Department of Energy, Government of Brazil, India and Indonesia

[3] Oil Refinery Infra Outlook 2011: An Unloved Energy Asset? By Gaurav Sharma, November 10, 2010. Please note report was written prior to the financial close of Jubail Refinery, Saudi Arabia was made public. [Available here](#) .

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