

There is an interesting picture emerging in terms of the poker game currently being played between the oil Majors and the Services companies. What follows is my sense of some of the current industry dynamics from spending time recently with RDS, BP, Total and Pegasus-Global (services consultant):

-- Going back 6-9 months, Service companies were suggesting that NOC project awards could provide some bridging for their backlog while significant IOC awards took time to feed into the system (roughly expected to be within a 12 month timeframe). Speaking to some of the IOCs at that time, this expectation was not unreasonable. Six months on and it seems that most of the Service names are singing the same tune (ie likelihood of further NOC awards, while those from the Majors would start to come through within 12 months).

-- BUT I GET THE SENSE THAT THE MAJORS' ATTITUDE TOWARDS TAKING SIGNIFICANT FIDs (in the move from sprint to marathon projects) MIGHT HAVE SHIFTED IN THE INTERVENING PERIOD AND IT IS NOT CLEAR TO ME THAT SERVICE COMPANIES HAVE REALISED THIS (Services companies are still thinking of sort of a U shape, whereas the trajectory might be closer to that of a bath tub – Pegasus-Global reckon that E&C companies are not on top of this debate). In a nutshell, it seems that the oil Majors might be prepared to delay FIDs on significant projects (with a few exceptions at the project level and Exxon being typically countercyclical) for quite a bit longer than 12 months (when pushed, Total reckon they could avoid taking major FIDs without uncomfortably impinging their future production/reserves profile for as long as 2 years, while Pegasus-Global believes this could extend out to 3+ years). The base factors remain the same - uncertainty over the crude price on a 2-3 year view, the cost dynamic and the carbon issue (Exxon is the exception). But I sense there have been some subtle factors on each of these drivers over the past 6-9 months that seems to be pushing out the timeframe for FIDs being taken (which I think is not simply a function of talking their own book on this):

(a) the majors are more definite in their view that fundamentals do not support crude prices at current levels (they are not seeing any pickup in demand and the higher the financial players push prices, the greater the scepticism). Beyond this, while many still seem confident that a lack of new projects will lead to a supply crunch c2013, with higher prices (towards \$80/b?), it seems that uncertainty over longer term demand patterns post the most recent price shock is gaining more traction in boardroom discussions and clouding the medium/long term crude pricing picture;

(b) the notable change that has taken place in the cost part of the equation is that projected activity in Brazil/West African deepwater (post more recent exploration successes) has led the companies to suggest that (the significant) deepwater-related costs are going to be a lot more sticky than previously envisaged, alongside what most accept will be resilient labour costs = overall services cost equation might not come down far enough to ensure competitive project returns (critical for financial discipline to convince investors of attractive cash generation, and hence dividends); and

(c) carbon is being discussed by these companies a lot more actively, both internally and externally, vs 6-9 months ago. This is now being seen as a potentially material part of costing projects across all part of the oil chain and the uncertainty relates not only to timing of any legislation from the US (taking a back seat while Obama fights the battle on healthcare), but also trying to gauge what cost might be involved. In short, the Majors do not expect any clarity on what will be an important variable anytime soon (Pegasus-Global think it will take the better part of a year just to start to encompass possible effects of regulatory changes).

All in all, speaking to the Majors and the likes of Pegasus-Global does not suggest any material/sustainable flow of FIDs from the Majors is about to happen anytime soon, which raises a ? over Services company backlog expectations through 2010 - I think these remain far too optimistic. As Kris Nielsen from Pegasus notes, there are three kinds of backlog - in your pocket, in sight and in your dreams, and I suspect it is the latter that being reflected in some of the current share prices. In the meantime, the clock is ticking in terms of the legacy backlog that is being used up. Pegasus-Global believe that a pickup in significant project awards will only be in 2011 (but more normal conditions in 2012), a view also expressed by ODS Petrodata at our conference last week.

-- But there is another factor that will most likely delay FIDs by more than many expect and the recent Gorgon decision shows the way here. Part of the reason (other than strategic imperatives

and the structure of the FID decision within the JV) that Gorgon was given the go ahead was because costs had been negotiated lower (the 'first sharpening took around 7% of cost off, to around 2007 levels, while the 'second sharpening' took costs down to 2006 levels) to the point it was deemed to generate a competitive return for the companies involved. But what allowed costs to come down was the fact that Gorgon has been on the drawing board for a considerable time, and with a fair amount of design and engineering specs already having been done (work had been undertaken for years prior to this decision), Chevron et al were in a position to further derisk this project for the tenderers (obviously greater project clarity = lower tender pricing). In fact, against the usual 18-20% of engineering design done by FID, Gorgon stood at closer to 60% when the decision was taken. The point here is that many of the new projects due for FID simply do not have the level of engineering design that might allow costs to be driven down to attractive levels for the IOCs and besides this, the tendering and retendering process can take years to complete. This all takes time. As an aside, Pegasus-Global estimates that at \$60/b long term, service costs need to come down by at least a further 10-15% to render many projects competitive.

-- As to further NOC awards, Pegasus-Global makes the point that there are signs of this slowing (confirmed by others we speak to who suggest many of the recently awarded NOC contracts are one-off in nature).

-- Having indicated that the resilience of service companies' backlog looks increasingly suspect over the next 12-18 months, there are other important factors that warrant closer scrutiny. Pegasus-Global are of the view (hard to disagree with this) that not only will the process described above (as highlighted by Gorgon) impinge on these companies' topline (and possibly margins), but the fact Asian contractors are now being ultracompetitive (including offering preferential terms on payment) will also be felt. But more importantly, in the near term Pegasus are quite clear in their view (and I agree) that most of the benefits seen from existing legacy projects (mostly bid 18-24 months ago when prices were high) in terms of release of contingencies will be largely exhausted by the time we get to Q4 (other industry observers share this view) - and if anything, there is genuine surprise that these companies did not smooth their Q1/Q2 results to a greater degree (but then, lest we forget, they are inherently optimistic).

-- One final point that is worth noting in relation to the carbon issue is the view that the Majors portfolio mix will gravitate towards natural gas exposure given its relative placing on the environmental scale.

Conclusions:

INTEGRATED: not an easy one, but if crude prices weaken, material delays to major FIDs will most likely be seen in a positive light as it might allay any concerns on balance sheet gearing getting to uncomfortable levels and highlight that companies' are staying disciplined on ensuring competitive returns/strong cashflow on important projects going forward. While it dampens, when was the last time anyone bought the majors for production growth (Exxon stands out in this regard)? Like **BP**.

SERVICES: need to tread very carefully here in the next 6-12 months in relation to margins and backlog growth - if you have to be invested in this space, stay with the relative defensiveness/superior visibility of **AMEC and Saipem**. The medium/long term outlook (really 2012+) is very upbeat with general & oil/gas

Specialist Sales
Deutsche Bank - European Oil & Gas Team
Tel: +44 207 547 3410
Email: john.syropoulo@db.com