**E&P transaction market on Norwegian Continental Shelf**

“Transactional activity in the energy sector - market snapshot” reported on the status and trends of the transactional market within oil and gas exploration and production (E&P) on the Norwegian Continental Shelf (NCS) in late 2015. After the oil price collapse in the second half of 2014, oil prices seemed somewhat less volatile at the end of 2015, with a Brent floor at $40 per barrel. Less than a month later, the oil price fell below $30 per barrel, and the reduction in investment, cutting of operational costs and activities and downsizing in E&P and offshore service companies continued. The number of applicants in the 2016 NCS licensing round in pre-defined (mature) areas dropped to 33 from 47 in 2014 and 43 in 2015. In January 2014 56 companies held interest in NCS production licences; there are now 47, with several companies believed to be exploring exit possibilities. This update gives a picture of the current NCS market and discusses some of the fundamental drivers and trends looking ahead.

**Background**

In the early 2000s the Norwegian authorities introduced several measures to stimulate E&P activities on the NCS, including:

• introducing a tax refund regime for exploration costs (the Norwegian state covers 78% of the exploration cost);
• opening the NCS to a wider variety of players by lowering the minimum requirements with respect to organisation, experience and financial strength; and
• organising annual licensing rounds for acreage in mature areas.

The objective of the measures was to incentivise further exploration activities, particularly in mature areas, and attract smaller entities with a profile and cost level that permitted development of marginal fields and tail-end production. The number of E&P entities on the NCS increased rapidly in the following years and acreage that had previously been discarded by international majors was re-awarded. The prime examples of the measures’ effect were the discoveries of the Ivar Aasen, Edvard Grieg and Johan Sverdrup oil fields. These discoveries were all made in mature parts of the NCS, and both operators of these discoveries – Lundin (Edvard Grieg and Johan Sverdrup) and Det Norske Oljeselskap (Ivar Aasen) – commenced their NCS activities around 2005 (Det norske oljeselskap had existed on the NCS prior to this, but it changed profile and significantly increased the level of NCS activities in 2005).

The current low oil price has demonstrated the NCS’s exposure to oil price fluctuations, as average NCS oil field developments traditionally break even even at an oil price in excess of $50 per barrel. The new reality has stalled the development of several oil fields, both small and large. Moreover, discovery and development assets are currently transacted at limited or no value, and in a weak capital market the chances of obtaining development funding have been limited or non-existent for smaller entities.

Since the discovery of the giant Johan Sverdrup oil field in 2011, exploration results in the North Sea and other more mature parts of the basin have been disappointing. The offering of new areas in the Barents Sea for E&P activities has resulted in renewed interest in the NCS and recent discoveries in these areas have strengthened the interest for northern parts of the shelf. On the other hand, although 26 entities had submitted applications for acreage in the 23rd regular licensing round which contained acreage in the Barents Sea, only 13 entities were offered licences in May 2016. Of the 10 licences awarded, Statoil, Lundin and Det Norske Oljeselskap (now Aker BP) were awarded a participating interest in nine and the operatorship in eight — it seems that the Barents Sea game is now played predominantly by a chosen few. Although this is in line with the Norwegian authorities’ policy for awards in virgin areas, it may have severe consequences in the current market: in correlation with other factors, it marginalises the NCS upside potential for small and mid-cap entities and exploration-focused players.
Trends in transactional market
The NCS transactional market has long been characterised by a high annual number of transactions of assets in all phases of petroleum activities. The transactions are made under the well-established NCS model agreement for the sale and purchase of licence interests (SPA). The combination of the model SPA and after-tax treatment of the consideration enables the swift execution of transactions, as it allows the parties to focus negotiations on the core elements of the transaction rather than tax optimisation and transactional non-issues. All key information relating to NCS production licences, such as the distribution of participating interest, is publicly available through the Petroleum Register and thus time-consuming rounds to verify title are avoided.

Until the model SPA was amended this year, a two-year grace period (where the seller remained liable for events that occurred prior to the effective date) limited the need for due diligence reviews. Several players and lawyers feared that the exclusion of the grace period in the new model SPA would slow down transactions by requiring more extensive due diligence reviews. Some players still request the use of the old model SPA. However, the overall perception is that the new SPA has hardly affected the transactional market, as there is limited need for due diligence reviews in respect of exploration phase assets, and development and production phase transactions were already subject to material due diligence reviews prior to the 2016 amendment.

The total transactional volume on the NCS has fallen significantly over the past two years. To date, the total number of completed asset transactions (excluding mergers and corporate acquisitions) in 2016 is 58, while the total number for 2015 was 71. For the years 2012, 2013 and 2014, the numbers were 114, 141 and 124, respectively. This is partly due to companies’ general reluctance to incur costs. For exploration asset transactions, the reduction is also a result of low exploration activity levels, as well as additional costs due to licence obligations under the mandatory work programme. The high oil price volatility has made it difficult to agree on price assumptions for development and production phase assets, for both corporate and asset sales. In many cases, the gap between the parties’ benchmark oil price for the transaction has been in the tens of dollars per barrel, rendering several transactions impossible.

For asset transactions, cost-intensive assets such as early-stage development assets and mature producing assets have suffered the most, as the oil price dropped below one-third compared to the three years preceding the oil price slump. Producing assets that have been transacted have achieved fairly competitive prices, but the most recent transactions indicate that even these assets have dropped in price. The low sample of transactions involving producing assets also makes it difficult to conclude that this market remains healthy. In general, the above price tendencies also apply to corporate acquisitions; however, the composition of the asset portfolio and asset and transaction fundamentals may, to some extent, be the cause of low pricing.

A common feature of recently completed transactions involving development and production assets is that they involve oil volumes on each side of the table, which helps to neutralise the challenges relating to benchmarking the oil price for the transaction. Examples include the merger of Det norske oljeselskap and BP Norge into Aker BP and swaps, such as Lundin’s acquisition of Statoil’s interest in the Edvard Grieg oil field in exchange for an ownership interest in Lundin, and Statoil’s sale of a 15% interest in the producing Gudrun field to Repsol for a corresponding interest in the Eagle Ford onshore US field. The most recent sales of development and production assets for cash consideration indicate that the expectations gap between seller and buyer may be narrowing, although several of these transactions have been characterised by highly motivated sellers without real options.

Looking at the 2015 to 2016 NCS exits (including acquisitions and mergers), most of the exiting companies are exploration specialist and small-cap entities, and several of the remaining exploration and small-cap entities are believed or known to be exploring exit opportunities. The market consensus is that the days of exploration specialist companies have passed (for now) and further consolidation should be expected.

The current NCS market offers several (confirmed and assumed) asset and corporate opportunities. Certain international majors are believed to be among the sellers; the question is whether this is a signal that they are looking for a possible exit or down-scaling of activities on the NCS. Additionally, several European utility and energy companies are believed to be sales candidates. Finally, there is a significant increase in the willingness to consider ‘structural solutions’ - an interest believed to be sparked by the merger between Det norske oljeselskap and BP Norge and the post-announcement share price rally. A common characteristic of most of the corporates for sale is that they hold at least one high-quality asset, which in a normal market would be fairly easily sold. In addition, interests in several development and production assets are currently marketed.

At present, a number of potential new entrants are known to be considering both asset and corporate acquisitions. These are typically entities with solid funding through strong private equity backing that are looking to acquire discounted reserves for development or production. Another common feature of these companies is prior NCS experience, through
management, previous activity on the NCS or previous interest in entering the NCS. Additionally, some of the smaller entities are believed to be changing profile from a strategy of organic growth through exploration to looking to acquire development or production assets.

**Projections for transactional activity**

Looking forward, there are several potential causes for the transactional activity level to remain low for exploration phase licences in the mature areas of the NCS. As observed, the number of small-cap entities and exploration specialist companies is decreasing, and companies looking to enter the NCS are not predominantly looking for exploration opportunities. The mature areas of the NCS have been thoroughly explored – drilling results have been disappointing in recent years and interest in these areas is diminishing. Furthermore, budget controls remain strong and there is limited willingness to explore when it is possible to acquire discovered resources more or less for free.

On the other hand, it is expected that the transactional market for development and production assets will pick up again, hopefully completing transactions before year-end. A fairly stable oil price (which seems to have survived the US election) in conjunction with reduced development and operational costs should help to mitigate this market. Positive signals from the capital markets indicate that development funding for smaller oil fields is no longer generally inaccessible. Also, as a result of concept changes, simplifications, improved efficiency and industry deflation, among other things, there will likely be an increase in the sanctioning of new developments going forward; during the third quarter of 2016, a plan for development and operation has been submitted for each of the Utgard, Byrding, Dvalin and Trestak fields.

*The article was written by Senior Lawyer Silje Wollan Einum and first published by ILO (International Law Office) November 21 2016.*