In 2017 we saw a continuation of the upturn in upstream M&A which began in late 2016. The oil & gas industry has been through a sustained period of focus on cost cutting but, as the oil price stabilises, many players are now seeing an opportunity to refocus on growth. In this atmosphere of cautious optimism, they are seeking to rationalise their portfolios in preparation for the coming years – balancing field life, development profile and geopolitical exposure. We think these factors will support the continued upward trend in upstream M&A in 2018.

In 2017 dealmaking in the global oil & gas industry saw its first annual growth since the ICE Brent Crude Oil price dropped below $40 in 2015. Deal values reached $270bn in the first nine months of 2017, compared with $192bn for the same period in 2016. Whilst exploration and production (E&P) companies still account for more than half of deal volume, the buyer universe continues to expand with traders and financial buyers growing their asset bases. Indeed, private equity firms accounted for $41.9bn of deals in 2017, including investments in mature basins such as the North Sea.

A common theme running through last year’s upstream oil & gas private M&A trends was the readiness of parties to adopt new deal structures and operating models in order to achieve successful outcomes. We have seen parties adopting more flexible consideration structures; departing from traditional approaches to allocation of liability for decommissioning costs; alliances between co-venturers aimed at maximising value by deploying specialist expertise; exits through joint ventures; and varied sources of upstream finance alongside the continued presence of private equity.

Against the backdrop of lingering uncertainty regarding the oil price, there has been an increased use of consideration structures that involve a deferred element contingent on the oil price, further discoveries or reserves, or significant project milestones. We expect this trend to continue. Similarly, we have also seen the use of royalty and similar arrangements, whereby a seller retains some cash flow interest in an asset; and deals being "sweetened" by giving purchasers options to acquire additional interests.

For decommissioning liability, sellers have traditionally sought a clean break, by allocating such liability entirely to buyers. This approach can become a sticking point on private M&A transactions involving the UKCS, with its notoriously onerous
statutory decommissioning regime. The price that a buyer can offer may be adversely affected not only by the significant cost of decommissioning, but also by the cost of providing security to the seller and co-venturers for decommissioning liability. These cost pressures are amplified where, as is often the case these days, an incumbent major is selling its late-life assets to a financial buyer who is using acquisition finance.

**Alternative approaches**

In recent deals we have seen buyers and sellers testing and using alternative approaches to allocating decommissioning liability, for example, the seller retaining liability for decommissioning costs in respect of the target assets, or retaining such liability up to a cap. We have also seen buyers and sellers discussing arrangements whereby the target assets would be retransferred to the seller at the decommissioning phase. This latter approach could be adopted for a variety of reasons - a seller who is retaining some liability for decommissioning may be able to carry out such decommissioning more efficiently and cost effectively than the current buyer, or may be in a better position to make use of available tax reliefs.

The split operatorship model is being discussed in more prospective basins. In ever diversifying operating environments, it is becoming harder for any single operator to be a master of all things. Therefore, upstream players have been forming joint ventures under which, for example, one party acts as operator for exploration operations, while another party acts as operator for development and production. This could also work with decommissioning operations. The purpose of this approach is to ensure that the strengths of each co-venturer are effectively deployed to maximise value from the relevant asset. More generally, incorporated joint ventures are enjoying an uptick. Traditionally, they are not common in the upstream but are being looked at again as developers look to tap new sources of finance from financial buyers or contractors, and they are useful for strategic alliances where a contribution of the two groups’ divergent portfolios has industrial logic.

**Financing deals**

Whilst less traditional sources of finance continue to enter the market (including prepayment and commodity streaming deals as well as bilateral facilities from debt funds) there has also been a significant return of bank capacity as the market stabilises. Also, debt deals are changing – we see hybrids of reserves based lending with both acquisition finance and project finance; and in some cases majors have been willing to provide debt too, alongside senior banks but with associated offtake and hedging arrangements. The next challenge is to consider how contractor balance sheets can support development financing.

In the UK the government is playing its part in facilitating M&A, and thereby re-invigorating a mature basin. In spring 2018 it will publish legislation for a technical consultation, which will allow companies selling UKCS fields to transfer some of their tax payment history to the buyers of those fields. The buyers will then be able to set the costs of decommissioning the fields at the end of their lives against the transferred tax history, with the aim of having sufficient tax capacity at the time of decommissioning to be able to monetise the full value of their decommissioning relief. Further, the UK government is proposing that the legislation will have retrospective effect for deals completing on or after 1 November 2018.

**Looking ahead**

If the oil price will be “lower for longer” the deal structures described above will evolve and become more widespread. The market is more fractured and complex than it was in an environment of $100 oil. The plurality of buyers, sellers and funders requires bridging tools to accommodate value gaps and the requirements of new entrants who are not traditional industrial and financial players.

The last three years have demonstrated the resourcefulness of the oil & gas industry. This is reflected in the new deal structures, operating models and sources of finance, which will play their part in reshaping the industry for the next generation.