

CNOOC to CUT Capital Expenditure to Counter Falling Oil Prices

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CNOOC Limited, China's biggest offshore oil and gas producer, said it will control output in the next three years as well as cut capital expenditure, in a bid to counter challenges from falling crude oil prices. CNOOC has fixed the net production target this year at about 475 to 495 million barrels of oil equivalent (BOE), which is 10 to 15 percent up from the estimated output of 2014 (432 million BOE). Production from China and its overseas operation account for approximately 67 percent and 33 percent respectively. CNOOC limited's net production target of 2014 was in the range of 422 to 435 million barrels of oil equivalent (BOE), including approximately 69 million BOE as a result of the acquisition of Nexen Inc. Experiencing the upward trend on costs in the industry in 2014, the company will utilize capital more prudently through the capex plan to support its business development in the future.

The net production targets for 2016 and 2017 are 509 and 513 million BOE respectively, representing 7 percent and 1 percent year-on-year growth, Zhong Hua, chief financial officer of the company, said in a recent news release. He said the company would apply "prudent principles" for operations, which included cutting the capital expenditure budget to about 70 to 80 billion yuan (US\$11.2 to US\$12.8 billion) in 2015, a 26 to 35 percent decrease from the estimated realized capital expenditure for 2014. At present, CNOOC has 93 offshore oilfields and 13 gas fields in production. In 2014, the company owned 200 offshore production platforms, compared with 146 in 2009. The estimated net production for 2014 is approximately 432 million BOE.

Exploration, development and production account for about 21 percent, 67 percent and 10 percent of

the expenditure respectively. Li Fanrong, CEO of the company, said CNOOC would pay more attention to cash flows against the backdrop of a "macro environment of low oil prices", as well as "optimize asset portfolio and capital allocation". But he ruled out the possibility of closing down some unconventional projects in the United States and Canada, including a shale gas project, though they are incurring huge investments and not generating any profit at initial stage. "A short-term closure of the projects will affect the performance in future," he said, adding that "this industry is cyclical. And I have faith in oil prices for the middle and long term."

Li said that "facing the complicated and highly volatile macro environment in 2015, the company will continue to strengthen management of internal operations and make efforts to meet annual operational targets." Meanwhile, the company will ensure an appropriate balance between short-term return and long-term development, and implement prudent capital investment plan in order to continuously carry out its ambitious "New Take-off" strategy. There will be seven new projects coming on stream, including the Jinzhou 9-3 comprehensive adjustment project which already commenced production. Both the Kenli 10-1 project and the Bozhong 28/34 comprehensive adjustment project located in Bohai are expected to reach peak production of around 36 and 30 thousand BOE per day respectively.

Within the year of 2015, the offshore oil giant plans to drill around 162 exploration wells and acquire approximately 36000 kilometers of 2-Dimensional seismic data as well as approximately 14000 square kilometers of 3-Dimensional seismic data. The reserve replacement ratio (RRR) is targeted at over 100 percent. In 2014, CNOOC

Limited also had an extensive exploration program and drilled roughly 155 exploration wells and acquired approximately 26700 kilometers of 2-Dimensional seismic data as well as approximately 19400 square kilometers of 3-Dimensional seismic data. Meanwhile, the company continued to strengthen deepwater exploration especially in South China Sea area.

The total capital expenditure budget is in the range of 70 billion yuan to 80 billion yuan in 2015 with a decrease of 26-35 percent over the estimated realized capital expenditure for 2014, among which the capital expenditures for exploration, development and production account for around 21 percent, 67 percent and 10 percent respectively. The company expects to achieve all of its annual targets by cost control and efficiency enhancement despite the lower capital expenditure.

Lower expenditure: good for CNOOC, bad for COSL

CNOOC cut its capital expenditure for the first time since 2010, reflecting the material impact on the company's business strategy from lower oil prices. CNOOC will budget total capital expenditure of 70-80 billion yuan for this year, down 26-35 percent from 2014. The budget cut is broad-based, from exploration (29-38 percent), to development (23-33 percent) and production (41-48 percent).

This capital expenditure cut is material – 20 percentage points higher than the market expectation – according to Morgan Stanley's Andy Meng and Daisy Li. This is likely to boost CNOOC's free cash flow to the positive territory if the Brent crude stays at US\$60 per barrel in 2015, estimates the bank. "We believe this cut is likely to become a material positive catalyst." Meanwhile, CNOOC pledged to meet its oil production growth targets. The company aims to produce 475-495 million barrels of oil this year, about 10-15 percent rise from 2014. Now the question is: how would CNOOC's capital expenditure cut affect its oilfield services provider China Oilfield Services or COSL?

In a nutshell, COSL should be safe. Morgan Stanley looked at COSL's revenue and earnings growth versus CNOOC's capital budgets in the past and concluded that COSL's earnings soared when CNOOC spent more on expansions but "when CNOOC cut capex by 20 percent in 2010, COSL only experienced a slight revenue decline of 2 percent, while earnings grew at 32 percent."

"In response to challenges from falling oil prices, we will control our costs and strive for effective implementation of our capital expenditure plan in order

to improve the overall performance of the company," commented Zhong Hua, CFO of the company.

Li Li, a research and strategy director at ICIS-C1 Energy, a consultancy in Shanghai, said the strategy of CNOOC showed its prudent expectations for oil prices in the next three years. Wang Zhen, a professor of China University of Petroleum, said CNOOC had a simpler business structure compared with the other two giants---CNPC and Sinopec. Unlike the other two, which have refining business and natural gas presence, CNOOC has limited downstream business to offset the pressure from lower crude prices. CNOOC posted a 4.6 percent decline in third-quarter sales as lower crude prices eroded earnings.

In addition, Moody's Investors Service says that CNOOC Limited's plan to reduce capital spending and increase production volumes are credit positive because it will mitigate the negative impact of falling crude oil prices on the company's debt metrics. The plan is also credit positive for CNOOC Limited's parent, CNOOC, because CNOOC Limited accounts for the majority of CNOOC Group's profits.

The International Energy Agency, however, offered a ray of hope amid negative sentiment for the oil sector in early 2015. The agency scaled down its 2015 non-OPEC oil supply forecast and said crude prices could see a recovery in the second half of the year. But some analysts are still cautious on Asian energy stocks. HSBC in late January 2015 downgraded China's oil giants on the assumption that an oil recovery would be long and slow. JP Morgan followed suit and said oil had not bottomed out and most of the government policies were against the oil majors. Some institutions believe that even if the oil prices stabilize, or even recover, the refining margins of Chinese refiners will still be under pressure.

For one thing, the Chinese government is raising taxes on refining products, which is directly squeezing companies' profit. Meanwhile, there is also the regional supply issue. While there is now less production in North America, more supplies are being built in Asia, which put added pressures on the existing players, UBS analyst John Chung said in a recent research note.

Wushi Oilfield to be on stream

Wushi Oilfield, an offshore oilfield 30 kilometers to the coastline of Zhanjiang in South China Sea, will be completed and put into operation in 2017. The reserves in the oilfield have been verified to be abundant, as the production cycle can last more than 20 years after it's put into operation. CNOOC Limited has put an investment of

more than two billion yuan (about US\$320 million) into the construction of the oilfield, which will have an annual output of one million cubic meters of crude oil. Offshore oil development has a relatively low production cost as compared to deepwater oil production.

Wushi Oilfield will bring great economic benefits to Zhanjiang when it goes into operation, according to the Zhanjiang Offshore Petroleum Tax Bureau. Wushi Oilfield will drive the development of downstream industries in Zhanjiang, and create more than 200,000 new jobs. Oilfield development also plays an important role in increasing government tax revenue. According statistics from Zhanjiang Offshore Petroleum Tax Bureau, tax revenue from marine oil and gas exploration accounted for 21.98 percent of the national tax contributed by Zhanjiang, and 23.81 percent of the local government's tax revenue.

CNOOC signs production sharing contracts with SK

In mid-February 2015, CNOOC Limited announced that its parent company, CNOOC, signed two production sharing contracts with SK Innovation Co., Ltd. (SK) for Blocks 04/20 and 17/03 in the South China Sea. The two blocks mentioned above are located in the Pearl River Mouth Basin. Block 04/20 covers a total area of 5,138 square kilometers and has a water depth of 50-100 meters. Block 17/03 covers a total area of 7,686 square kilometers and has a water depth of 50-100 meters. Both blocks are included in CNOOC's Open Blocks in Offshore China for the year 2012.

According to the terms of the production sharing contracts, SK will act as the operator of the two blocks mentioned above. The exploration costs required for exploration operations will be borne by CNOOC and SK in a proportion of 20 percent and 80 percent of participating interest, respectively. Both parties will conduct 2D seismic data surveys and drill exploration wells. Once entering the development phase, CNOOC has the right to participate in up to 60% of the working interest in any commercial discoveries in the blocks. After signing the above-mentioned production sharing contracts, CNOOC will assign all of its rights and obligations under such contracts, except for those relating to CNOOC's administrative functions to CNOOC China Limited, a subsidiary of CNOOC Limited.

As one of the three leading oil companies in China and one of the largest independent oil and gas exploration and production companies of the world, CNOOC is China's dominant producer of offshore crude oil and natural gas

and engages in the exploration, development, production, and sale of crude oil, natural gas, and other petroleum products. CNOOC is the only company permitted to conduct exploration and production activities with international oil and gas companies off the shores of China.

CNOOC's overseas LNG supply base starts operation

A liquefied natural gas (LNG) ship named Methane Rita Andrea carrying 60,000 metric tons of clean fuel from Queensland, Australia arrived at China's receiving terminal in Tianjin in early January 2015 – a shipment that is expected to help further improve the country's energy consumption structure. The operations have begun at the country's first overseas large LNG supply base. The move is important in developing China's natural gas industry and securing clean energy supply to China. The LNG supply base, located at the Queensland Curtis LNG project in Queensland, Australia, would supply CNOOC with 8.6 million tons of LNG annually for 20 years, said the company.

CNOOC signed LNG agreements with BG Group to purchase interests in the Queensland Curtis LNG project in Australia in 2010 and 2013, making it the project's second-largest investor and beneficiary. Under an agreement worth US\$1.93 billion last year, CNOOC buys LNG from British gas producer BG Group, increasing its stake in BG's Queensland Curtis LNG project from 10 percent to 50 percent at the same time. CNOOC imported more than 13 million tons of LNG last year, accounting for 72 percent of the country's total LNG imports in 2013. By the end of May 2014, CNOOC had built and put six LNG receiving terminals into operation in China's coastal regions.

"The success of this first cargo shipment to China from the project in Australia will have a significant impact on global natural gas industry," said Wang Yilin, chairman of CNOOC. With CNOOC as the second-largest shareholder and investor in the Curtis project, it is the first time that China participated in the full industrial chain of an LNG project. With China aiming to raise the share of clean energy within its total primary energy consumption mix, natural gas has become increasingly important.

On the one hand, the state-owned energy players are investing in conventional natural gas and unconventional resources including shale gas production to raise domestic output. On the other hand, energy companies led by CNOOC are increasing their LNG imports to meet growing domestic demand. 