



## Low success rate of Norway's offshore oil and gas activities drowning the sector's credit profile

By [Shania Mustika](#)

Although the Norwegian oil-workers union managed to reach a [wage agreement](#) with oil companies to avoid a strike that could potentially cut the country's oil and gas output by about 440,000 barrels of oil equivalents per day – about 11% of the country's total production – outlook in the country's offshore oil and gas sector does not brighten. Norway is the world's 15<sup>th</sup> and 3<sup>rd</sup> largest producer of oil and gas respectively and half of its economy's export is driven by oil and gas. However, Norway's offshore oil and gas companies have been facing declining production and a lack of substantial results despite intensified efforts in exploration and discovery, therefore heightening companies' credit risks from financial leverage. As with commodity sector in general, it is also facing pressure from increasing oil price volatility.

Naturally, the offshore oil and gas sector is a major beneficiary (or victim) of oil price fluctuations. An increasing oil price since 2016 has indeed delivered the promise of recovery among the country's offshore oil and gas companies as indicated by the falling NUS-CRI 1-year Aggregate Probability of Default (Agg PD) that reached a record low in July 2018 (Figure 1). However, this recovery was short-lived, as the oil price experienced a renewed plunge late last year. This recent increase in oil price volatility also further adds on to the uncertainty of the offshore oil and gas credit outlook.

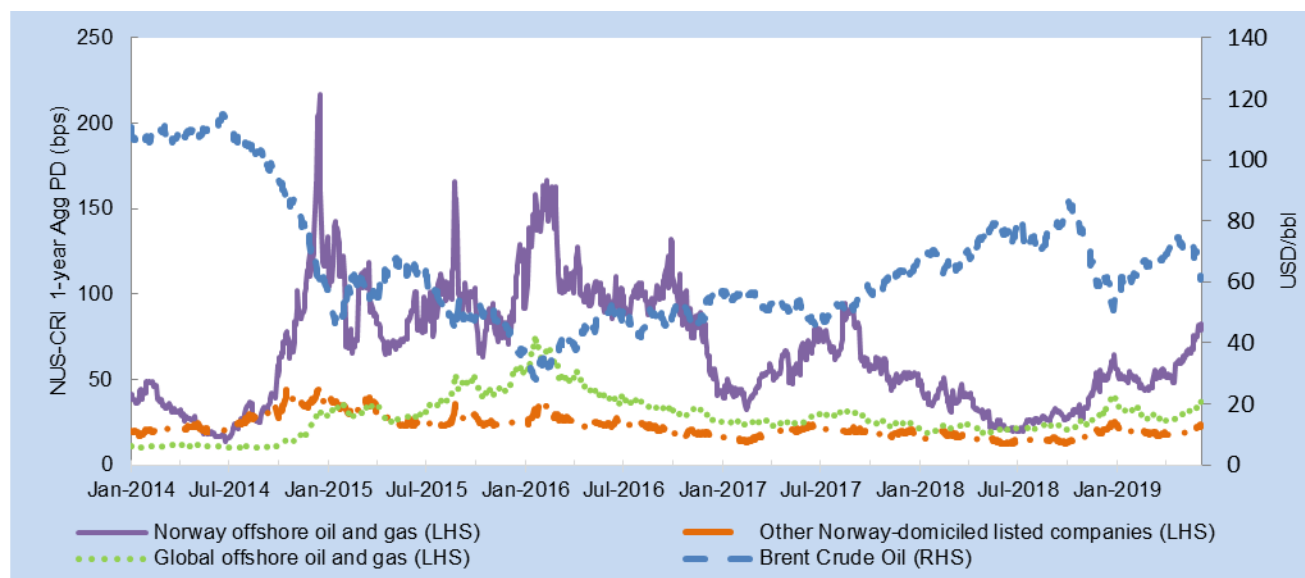


Figure 1: NUS-CRI Aggregate 1-year PD for Norway offshore oil and gas sector (E&P and drilling companies), global offshore and other Norway-domiciled listed companies, Brent Crude Oil price. Source: NUS-CRI, Bloomberg

With legacy wells reaching their final production phase, Norway's crude oil production has shown a decreasing trend throughout 2019. Exploration and drilling activities in the Norwegian Continental Shelf (NCS) are therefore crucial for producers to ensure long-term supply. The Norwegian Petroleum Directorate 2018, in its 2018 report, estimated that nearly 50% of oil and gas resources are yet to be discovered. With the decreasing reserves and announcement of opportunity, many oil producers have been engaging in development and exploration activities.

Yet exploration and drilling activities are capital-intensive and expensive by nature. While bigger players are able to capitalize on equity financing, smaller players are more reliant on the debt market and bank financing, translating into greater financial leverage. Worries arise because despite so much effort being put into exploration, there is a lack of substantial results except for the two major successful discoveries, both of which are operated by Equinor ASA, Norway's largest oil company. [Equinor ASA](#) has been able to reap the fruits of

the two successful exploration projects and hence increased net income, but others struggle to stay afloat. Median net income for Norway offshore oil and gas companies have entered the negative zone and total debt/equity ratio lies above the global median. High financial leverage, coupled with negative net income (as shown in Table 1), has seen smaller players like Dolphin Drilling ASA recording the currently highest NUS-CRI 1-year PD among Norwegian offshore oil and gas companies, peaking at 5135.41bps in November last year (Figure 2). Moreover, Dolphin Drilling ASA has two USD 1bn debt maturing in late 2019 and 2020 respectively and the company has been in talks for [restructuring](#) by selling off its current fleets and transferring its debt and swaps to its holding company.

Net Income (bn USD)				
	2018Q2	2018Q3	2018Q4	2019Q1
Equinor ASA	1219	1665	3366	1711
Dolphin Drilling ASA	-206.6	-101.9	-153.1	N/A
Norway offshore median	1.36	-0.78	-6.19	-0.078
Global offshore median	-0.11	-0.035	-0.081	-0.10
Total Debt/Equity				
	2018Q2	2018Q3	2018Q4	2019Q1
Equinor ASA	64.48	62.0	59.84	66.05
Dolphin Drilling ASA	213.75	307.89	1090.88	N/A
Norway offshore median	64.23	60.94	66.19	66.05
Global offshore median	24.95	26.69	27.72	32.47

Table 1: Net Income and Total-Debt-to-Equity ratio for Equinor ASA, Dolphin Drilling ASA and the industry median for Norway and global offshore oil and gas companies. Source: Bloomberg

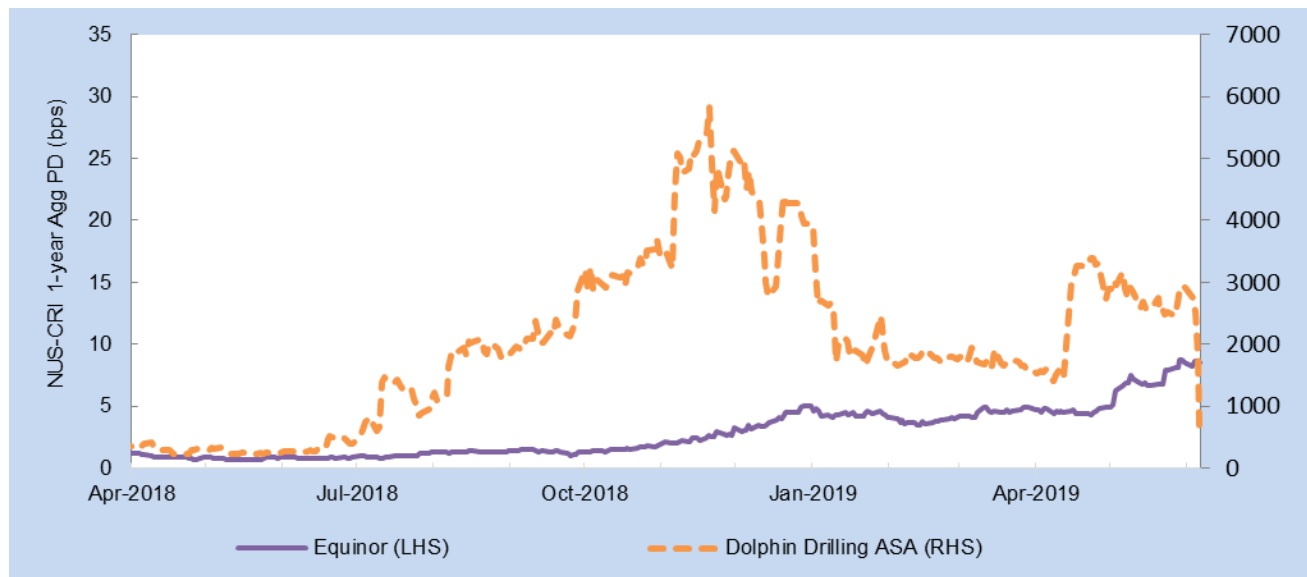


Figure 2: NUS-CRI 1-year PD for Equinor ASA and Dolphin Drilling ASA. Source: NUS-CRI

Norway's overall exploration performance and activities has declined in the past 5 years, according to [Westwood's Norway Exploration Performance 2014-2018 report](#). Comparing 2010-2014 figures to that of 2014-2018, the number of exploration wells completed dropped by almost 25% and discovered commercial volumes by more than 50%. Both commercial success rates and technical success rates fell by 10 and 3 percentage points respectively. Norway's offshore oil and gas sector is facing a bleak outlook, as this great amount of resources invested in exploration and development activities does not bear enough fruits.

The two major discoveries – Johan Sverdrup in the North Sea and Johan Castberg in the Barents Sea – are expected to [reverse](#) the overall production decline in the coming years. The NUS-CRI Aggregate Forward 1-year Probability of Default (Forward PD) of the offshore oil and gas sector based on June 6, 2019, data mimic the increased short-term risk due to increased financial leverage, showing upward trend that peaks in March 2021 (Figure 3b). It later falls, indicating potential improvement given the increased production potential. The NUS-CRI Aggregate Forward PD represents the credit risk of a company in a future period. For instance, the 6-month forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 1 year plus 6 months, conditional on the firm surviving the initial 6 months.

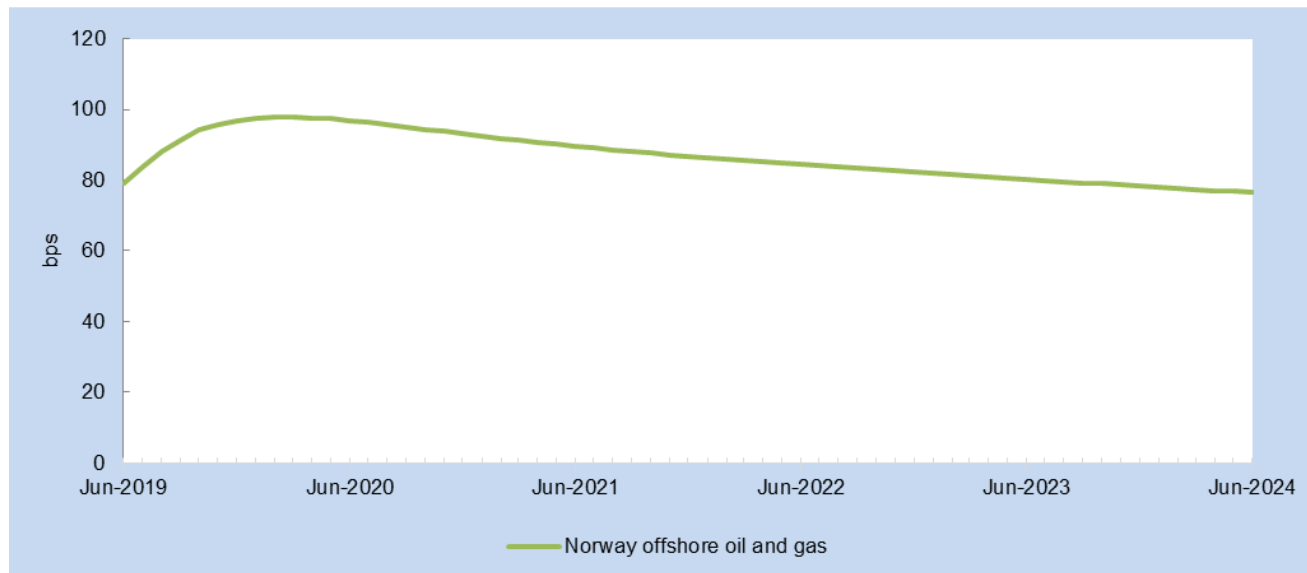


Figure 3: NUS-CRI Aggregate Forward 1-year PD term structure for Norway offshore oil and gas companies as of June 6, 2019. Source: NUS-CRI

However, prospects beyond the 5-year horizon remain shaky. Norway’s production is at risk of declining [without additional projects to sustain it beyond mid-2020](#). The decline in enthusiasm, or even confidence in the sector is also demonstrated by the country’s [announcing of divestment](#) of its sovereign wealth fund from firms engaged solely in oil and gas exploration. The Government Pension Fund Global (GPF) said that this was to protect the Norwegian economy by reducing exposure to oil price falls. Although none of the 134 dumped companies are of Norwegian origin, this event further highlights the movement away from oil and gas. The sector could also foresee additional pressure from the growing emission-reducing campaigns both nationally and globally, potentially resulting in less favorable regulations and falling demands. For instance, [Norway’s opposition Labor Party decided to withdraw its support for oil exploration offshore the sensitive Lofoten islands](#) in Norway’s Arctic, keeping the area off limits from drilling. Lofoten is a crucial element for Norway to maintain production as reserves from other legacy wells are being depleted. If policy initiatives, investments and consumer preference continue to shift towards a more carbon-friendly stance, the likely consequences – price volatility, weak profitability and tight financing – may pave way for the country’s industry to enter its sunset phase.

<p><b>Credit News</b></p>
<p><b>China's 'mini-Lehman' moment to spur smaller bank consolidation</b></p> <p><b>Jun 7.</b> China is looking to consolidate its smaller banks as to avoid any system disruption in the midst of a trade war with the United States and with a slowing economy as a backdrop. Smaller banks have been funding themselves through shadow banking products and some banks have not been publishing up-to-date financials. Having even one or two banks collapsing poses as a significant threat to the whole banking system as smaller banks make up 26% of total market share of financial institutions. (<a href="#">Reuters</a>)</p>
<p><b>RBI stops short of specific steps to aid India shadow banks</b></p> <p><b>Jun 6.</b> The Reserve Bank of India of India (RBI) has recently announced a cut in the interest rates and is ready to take all the necessary steps required to ensure financial stability. The weaknesses of the market in this sector were exposed after a series of defaults by IIFL and DHFL which further forced the government to intervene. It will form a committee to review its liquidity management framework would continuously monitor the NBFCs and housing finance companies to have a robust well-functioning NBFC sector. (<a href="#">Bloomberg</a>)</p>
<p><b>Policy-bank surge drives rise in offshore holdings of China yuan bonds</b></p> <p><b>Jun 6.</b> A surge in holdings of policy-bank bonds likely boosted offshore holdings of Chinese yuan-denominated bonds to a record high in May, as a result of their inclusion in a major global index aided inflows and risk aversion in the market. China’s policy banks, including China Development Bank, the Agricultural</p>

Development Bank of China and the Export-Import Bank of China, serve to fund Beijing's policy initiatives. Their bonds are highly liquid and offer higher yields than government bonds of the same tenor as well. Offshore holdings of Chinese government bonds also surged, standing at a record CNY 1.14tn at the end of May, up CNY 24.98bn over the month. The growth of government and policy-bank bond holdings indicates that total offshore holdings likely hit a new record in May for a third consecutive month. ([Reuters](#))

#### **Credit markets flash a liquidity warning that Pimco saw coming**

**Jun 5.** A key gauge of trading conditions in riskier bonds, the bid-ask spread, is reaching close to a high last reached in December. The bid-ask spread for global junk bonds reached 0.96 cents per dollar as compared to the highest of about 1.08 cents per dollar during the December-January rout. It rose sharply in the second quarter of 2019 as compared to a calmer first quarter as ample demand for risk assets kept corporate trading well-oiled. The bond market is experiencing patchy liquidity due to a legacy of post-crisis regulation that has thwarted banks' ability to hold inventory of corporate bonds and the increased volatility due to the ongoing trade war and political risks in the UK and Italy. ([Bloomberg](#))

#### **A near default in China gives bond hedging sellers jitters**

**Jun 4.** Sales of Chinese credit risk mitigation warrants (CRMW), a bond-market hedging tool similar to credit default swaps, have dwindled since their start in October 2018 after a two year pause. A recent triggering of an investor protection clause on two of Beijing Orient Landscape & Environment Co.'s bonds, which bondholders later waived as a non-default event, has served as a vivid reminder of the currently heightened default risks in the young Chinese bond markets for CRMW underwriters. Although no CRMW needed to be paid out so far, sales of CRMW have dropped from 27 in November 2018 to 7 in May 2019. ([Bloomberg](#))

**Global bond market has biggest inflows in more than 4 years** ([FT](#))

**Chances of Fed rate cut rise as trade war escalates** ([FT](#))

**Junk-bond, loan ETF outflows among biggest ever amid turmoil** ([Bloomberg](#))

#### **Regulatory Updates**

#### **India eases bad-debt resolution rules, giving banks more leeway**

**Jun 8.** The Reserve Bank of India is looking to relax rules to give banks with bad debts more time to come to an amicable settlement. The directive gives lenders 30 days to review delinquent accounts and also a further 180 days to implement a solution. These measures allow banks to do as much as they can to avoid insolvency and also give the government a chance to improve the banking system saddled with the world's worst non-performing loan ratio. Small businesses can also take this opportunity to restructure loans to drive credit and economic growth. ([Bloomberg](#))

#### **UK financial regulator clamps down on peer-to-peer investment**

**Jun 4.** The Financial Conduct Authority announced on Tuesday, that retail investors in the UK will soon be limited in how much money they invest in peer-to-peer lending, to a total of 10% of their investable assets. Current economic problems in the P2P market, which had substantially grown after the financial crisis to £6.1bn by 2018, had led to this decision. They aim to ensure adequate protections for consumers with limited financial knowledge. Rule changes concerning risk management and governance will also be implemented. ([FT](#))

**World's top economies lay out principles on debt sustainability at G-20 meet** ([Straits Times](#))

**Bank of England calls 'last orders' on Libor benchmark** ([FT](#))