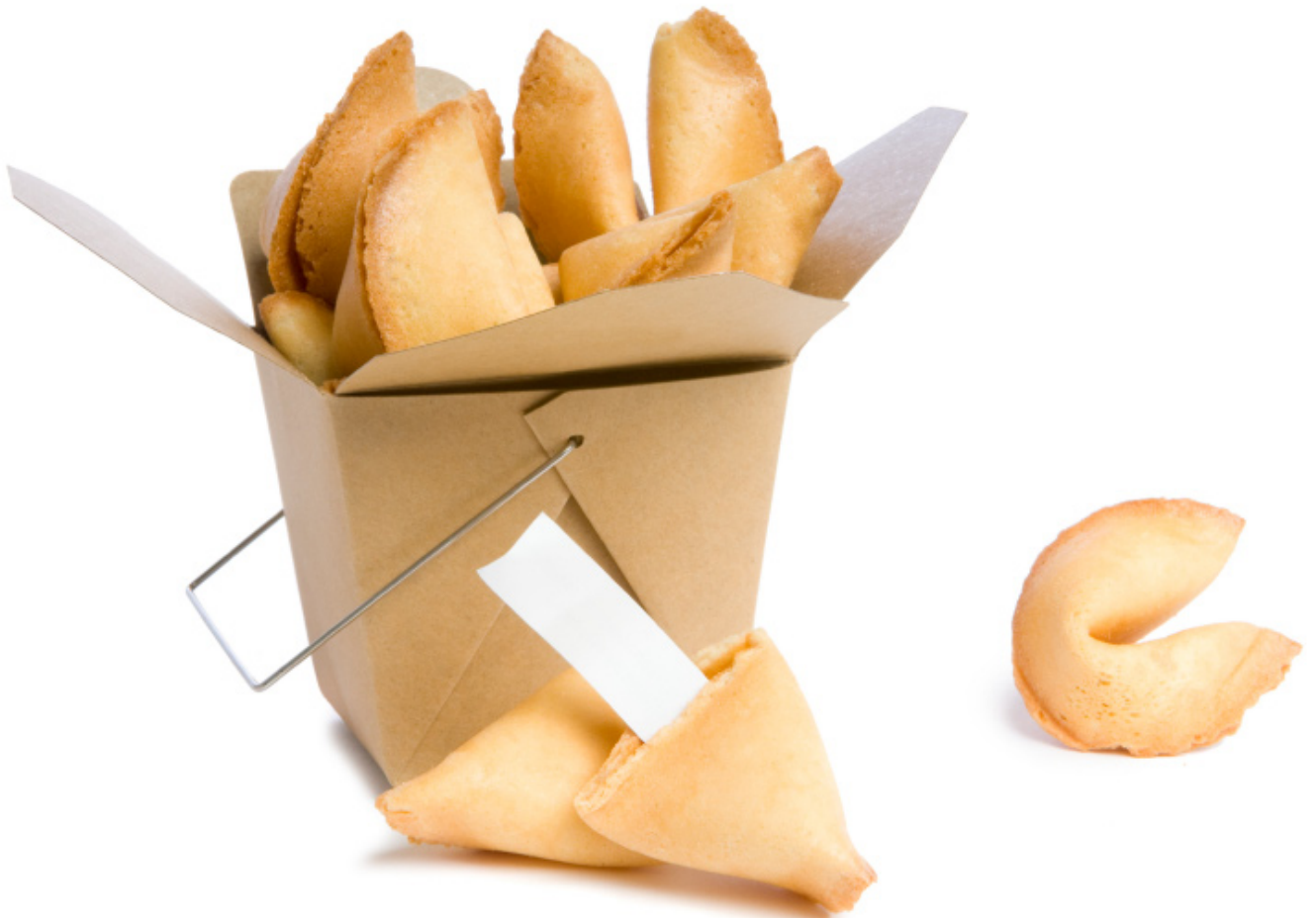


2009 Industry Outlook: Energy & Resources Challenging Times, Emerging Opportunities



Energy & Resources: Oil & Gas, Power & Utilities



As the Energy & Resources industry entered 2008, common wisdom held that “as energy goes, so goes the economy.” The sector’s outlook for the year was positive: Crude oil prices were rising, boosted by constrained supply and increased energy demand among developed nations and emerging markets such as China and India. Oil and gas companies and power and utility companies were earmarking their improved cash flows and balance sheets for potential acquisitions and new capacity additions to build out their resource base, although in the interim, several large oil and gas companies invested in share buy-backs until solid investments emerged. Rising exploration, production and refining costs were a concern, but companies were addressing them by focusing on enhanced operational efficiency and demand-side management programs.

One year later, the near collapse of the U.S. financial system and evidence of a growing global recession have turned the existing “common wisdom” on its ear. After surging to a record high of \$147.27 a barrel on July 11,

2008, the price of crude oil plummeted to less than \$50 in late-November, reaching its lowest point since May 2005.¹ Natural gas prices also dropped. The U.S. government reported massive increases in its crude and gasoline supplies, evidence that the shaky economy was curbing demand for oil.²

The world’s economy is no longer impacted by record high energy prices; it’s being driven by the economic downturn and continuing credit crisis. These constraints, in turn, are pushing down energy prices because of slowing demand – and that trend is expected to continue in the coming year. The new mantra for the Energy & Resources sector? “As the economy goes, so goes energy.” To survive in this altered landscape and to prepare for an eventual economic upswing, energy companies in 2009 should focus on maintaining liquidity, promoting operational efficiency, and expanding their long-term reserves through the drill-bit and acquisitions.

In addition to being buffeted by economic challenges, the energy industry also faces heightened and accelerated regulatory activity at the state and federal level, prompted in part by the election of Barack Obama and larger Democratic Congressional majority. Absent a comprehensive U.S. energy policy, the industry might see a push for stricter regulatory and environmental mandates to reduce greenhouse gas (CO₂) emissions. Increased funding is likely for alternative energy sources (with the exception of nuclear energy, which lacks support from the new administration). Such legislation will result in industry “winners” and “losers” and, in some cases, may dramatically impact company strategies as they strive to meet the dual demands of building new sources of energy supply through environmentally responsible means and increasing value to shareholders. Also, the energy sector may face increased environmental compliance costs due to stricter interpretation of existing legislation by a reinvigorated Environmental Protection Agency (EPA) and the possible appointment of a new Nuclear Regulatory Commission (NRC) chairman. Finally, during the presidential

¹ “Demand jitters push crude below \$50,” FT.com, November 20, 2008, http://www.ft.com/cms/s/0/f621914a-b6e9-11dd-8e01-0000779fd18c.dwp_uuid=f2b40164-cfea-11dc-9309-0000779fd2ac.html?ndclick_check=1

² Ibid

campaign, the new administration expressed support for reinstating the Windfall Profit Tax (WPT) on oil and gas companies, which would increase the cost of doing business, discourage new investments to boost domestic production and, as in the past, may lead to increased foreign imports of oil – the opposite effect the U.S. desires for energy security. Fortunately, it appears the incoming administration may be reconsidering this policy, given dramatically lower energy prices and the corresponding effect on company earnings. In anticipation of this dynamic regulatory environment, oil and gas and power and utility companies will need to develop a regulatory strategy that includes preparing for climate change legislation, planning for utility rate cases and addressing changing energy tax policies.

The dramatic economic and political events playing out on the national and world stage are generating other challenges for the Oil & Gas and Power & Utilities sectors:

Oil & Gas

Concurrent with managing the fallout from volatile commodities prices, oil and gas companies in 2009 will continue to need to address the longer-term, two-sided issue of increasing demand and constrained supply. Despite the recent slowdown in demand – a result of the economic downturn and developed nations' increased energy efficiency – the world's need for energy is increasing at an ever-faster pace. The International Energy Agency (IEA) projects that total world consumption for marketed energy will increase by 50 percent through 2030. If this projection holds true, the world will use more energy over the next 50 years than in all of recorded history.

Analysts agree that fossil-based energy – oil, gas and coal – will remain a dominant source of energy through the predictable future; however, supply is not keeping pace with demand. Oil and gas are getting harder and more costly to find and produce; accessible reserves today are located in difficult places such as deep waters and arctic regions. In addition, countries such as Saudi Arabia, Russia, China, Venezuela, Brazil and Malaysia, which own the world's largest reserves of oil and gas, continue to limit or

restrict access to international oil companies (IOCs). Finally, the ongoing threat of natural disasters or geopolitical conflicts also jeopardizes energy prices and supply levels. Energy independence became a theme in the 1970s and it is the recurring theme today. While oil and gas prices are temporarily depressed, there is little doubt that prices – and demand – will continue their rise as we move out of the global economic crisis. The governments of oil-producing countries are unlikely to provide access without creative deal structures with IOCs that produce win-win situations.

The price of energy is expected to lead the economic turnaround, although it is difficult to tell when in 2009 that will happen. Companies with solid balance sheets will find improved acquisition opportunities among companies that rely on the constrained debt markets to fund their drilling programs, as they are struggling in these difficult economic times. Therefore, even as many oil and gas companies deal with day-to-day challenges emanating from the current financial crisis, they need to keep an eye on the future and look at how their available assets could be used to fund new programs, partnerships and acquisitions that decrease the United States' dependence on imports, support increased domestic production, reduce energy requirements, promote efficiency, and spur the development of alternative/renewable energies.

On a positive note, fluctuating energy prices and tightened supplies may stimulate the development of energy-efficient technologies and processes that can be leveraged by a number of industries. Energy-intensive, manufacturing-based sectors such as Automotive, Aerospace & Defense, and Consumer Products have considerable incentive to look at options to lower their plants' energy bills, including onsite- or co-generation, solar and wind power, and energy-efficient, demand-side equipment. The Technology sector is continually increasing the number and variety of product offerings that use energy more efficiently (e.g., Energy Star-compliant appliances, lighting, home electronics, heating and cooling equipment). Finally, the Real Estate sector has an opportunity to increase the value of heretofore undesirable property by offering it as a location for solar- and wind-power generating equipment.

Power & Utilities

Among the top issues facing power and utility companies in 2009 is the continued trend toward rising input costs (e.g., coal, natural gas) and increased construction risks, as the sector seeks to build out new infrastructure (both generation and transmission) to meet demand in environmentally responsible ways. When it comes to the fuel source, companies are experienced at managing price volatility. However, the credit crisis has created significant cash flow challenges for the hedging programs of many companies.

Funding challenges are also a major concern for current construction programs. Because of high materials prices, the deployment of new technologies, stepped-up regulatory oversight, and a continuing talent shortage, the projected money that utilities will spend for large-scale construction projects in the next five years is often greater than their current balance sheets. Unfortunately, the current financial crisis makes it increasingly difficult for these companies to go to traditional financial markets and secure capital to finance important projects. This is resulting in deferral or postponement of some construction to allow for conservation of capital in the near term.

Some power and utility companies looking to address the dual challenges of rising costs and tight credit markets are exploring construction strategies that embrace multiple potential power sources (coal, gas, nuclear, alternative energies), but which offer flexibility to change direction as the landscape becomes more certain. In the short-term, the safe bets are construction of natural gas generation and investment in new transmission capacity, given the proven technology, which is acceptable from an environmental standpoint and relatively quick to build and bring on line. Other proven power sources and technologies – including nuclear and advanced coal-fired plants – will continue to have a high degree of uncertainty as to when they will move forward.

At first glance, taking a multi-pronged, flexible approach to new construction options will require more initial capital investment. Mergers or joint ventures, whether with domestic or international partners, could help to share construction-related risks, pool resources and raise capital. Also, it will be important for utilities to develop close

working relationships with state regulators to secure their early “buy-in” of the company’s strategy. That way, if the strategy shifts tracks down the road, the regulators should be hesitant to second-guess the company’s decision-making process.

In light of the challenges faced by the sector, the 2009 outlook for Power & Utilities could best be termed as “stable.” The current financial crisis suggests that investors will look for investments in “hard asset” companies with healthy balance sheets and stable earnings – which is the profile of much of this sector. Also, companies should be able to attract capital on reasonable terms if state regulators provide rate relief where needed, and show an inclination to support a flexible, long-term construction strategy. While growth in demand for energy may slow down or falter in the short term, the sector will continue to grow its asset base (and earnings) consistent with the need to meet the requirements for environmentally friendly energy supplies.



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