

2011 BDO OIL AND GAS RISKFACOR REPORT



The **BDO RiskFactor Report for Oil and Gas Businesses** examines the risk factors listed in the most recent SEC 10-K filings of the 100 largest publicly traded U.S. E&P companies. The risk factors were analyzed and ranked in order of frequency cited.

REGULATORY UNCERTAINTY AND VOLATILE OIL AND GAS PRICES ARE TOP RISKS TO E&P SECTOR

Risks in the oil and gas industry have never been more pronounced. Spills, natural disasters and geopolitical issues have hit the industry in rapid succession over the past year, setting off a wave of regulatory intervention and soaring oil prices. The ability to find and replace reserves has become increasingly critical following the failed OPEC vote in June – the first time in 20 years that OPEC was unable to reach an agreement on oil production levels. Fortunately, liquidity and access to capital seem to be recovering as the industry shows signs of increased confidence post-recession. Companies are investing in new technology to develop environmentally friendly drilling practices and more accurate assessments of exploratory drilling properties.

These are just some of the issues impacting the business risks identified in the first annual **BDO RiskFactor Report for Oil and Gas Businesses**, which analyzed the most commonly cited risk factors among the 100 largest U.S. public E&P companies. As reported in a [CNBC exclusive interview](#) with BDO's Charles Dewhurst, national leader of the natural resources industry practice, the analysis pointed to "political heat from Washington and volatility of the price of crude" as top risks, cited by all 100 companies. In order to hedge against the ongoing regulatory battles, Dewhurst told *CNBC*, "[Oil and gas companies] have had to make their case that the inherent risks of searching for and drilling for oil warrants the special incentives that the industry receives."

▶ Read more

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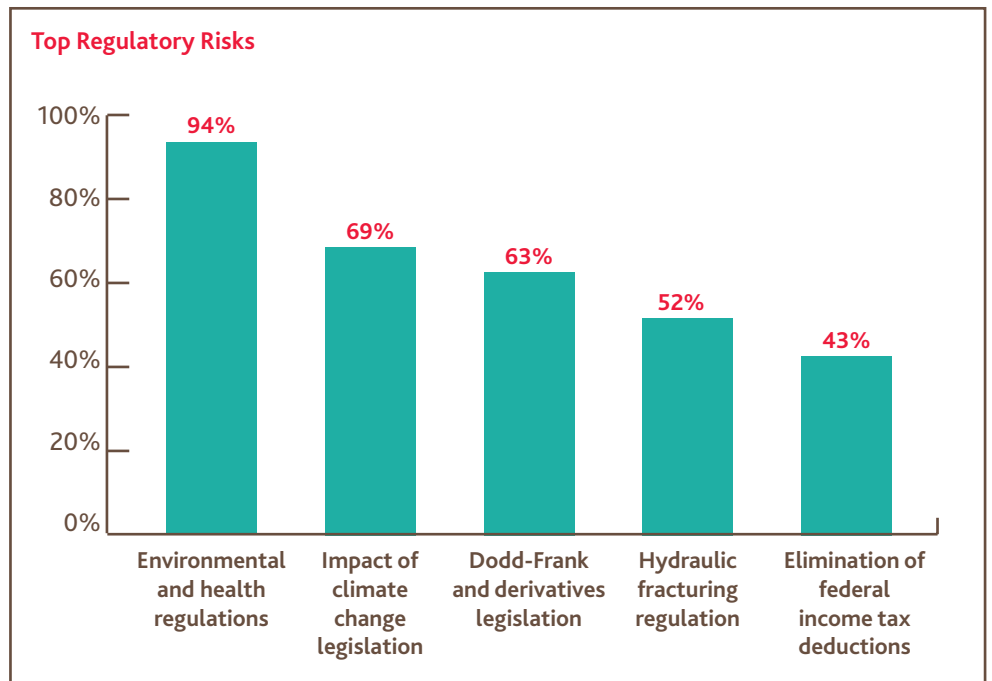
Volatile oil and gas prices and regulatory concerns are the underlying issues that have long been prevalent in the industry and are likely to remain at the top of the list for the foreseeable future.

► REGULATORY RISKS RUN RAMPANT

Political battles are being waged over a host of industry issues, from environmental restrictions, greenhouse gas emissions and climate change, to derivatives legislation and elimination of tax deductions. The top 100 E&P companies were careful to include these and other regulatory risks in their 10-K filings this year – taking a comprehensive approach to ensure legal coverage in the event that a major regulatory change forces a project or drilling operation to shutter. However, as Dewhurst told *CNBC*, the industry has been successful in highlighting that, “much of the oil and gas exploration is done by smaller entrepreneurial companies that need the tax incentives to fund the exploration.” These issues were also at the forefront of the **2011 BDO Energy Outlook Survey**, which found that 54 percent of chief financial officers (CFOs) at oil and gas E&P companies felt that “legislative changes” would be the most important factor inhibiting the growth of the U.S. oil and gas industry in 2011.

► REPLACING AND ESTIMATING RESERVES IS A RISKY BUSINESS

Replacing reserves ranks #3 out of the 20 top risk factors for E&P companies (cited by 98% of companies). New reserves threaten to uncover dry wells or unsatisfactory levels of production, and industry competition is fierce (cited by 87% as a risk factor), with companies battling over the acquisition of new drilling properties. Estimating reserves is an inexact science, and 96 percent of companies are concerned over the financial fallout of inaccurate reserve estimates. As finding sizeable new oil reserves becomes increasingly difficult, natural gas promises to bridge the supply/demand gap in the U.S., with significant discoveries made in recent years,



primarily in the various shale formations. With the balance between oil reserves and natural gas reserves tipping more heavily on the side of natural gas, we can expect risk factors around environmental concerns and hydraulic fracturing regulations to increase in the near future.

► OPERATIONAL HAZARDS COUPLED WITH INADEQUATE INSURANCE COVERAGE MAGNIFY RISK

The Deepwater Horizon spill caused major ripples throughout the industry, so it comes as no surprise that operational hazards are #4 on the list of top risk factors (cited by 97% of companies). Blowouts, spills, injury and loss of life are associated risks included in this category. Disruptions due to natural disasters and extreme weather conditions hold similarly high concern for companies, ranking fifth. Adequate insurance coverage is critical to mitigate the liability of such disruptions, and was ranked tenth on the list of risk factors, stated by 87 percent of companies.

“With natural gas and, particularly, oil being finite resources, a company’s track record of replacing its oil and gas reserves has always been a key performance metric.” – Dewhurst, *CNBC*.

“The factors further down the list, in the 65 to 75 percent level, present some very telling truths about how E&Ps view life in 2011.” – *Energy Metro Desk*

▶ COUNTERPARTY RISK REMAINS A CONCERN, BUT LESS SO THAN EXPECTED

Three-fourths (75%) of companies cited counterparty risk (i.e., “credit or financial risk of partners, customers, vendors or suppliers”) in their risk factor statements this year, ranking #15. While this is still a significant percentage, it was probably much higher on the list a year or two ago, Dewhurst told *Energy Metro Desk*. “This seems to suggest we are growing strongly out of recession,” he said.

▶ LIQUIDITY IMPROVES; COMPANIES PROCEED WITH CAUTION

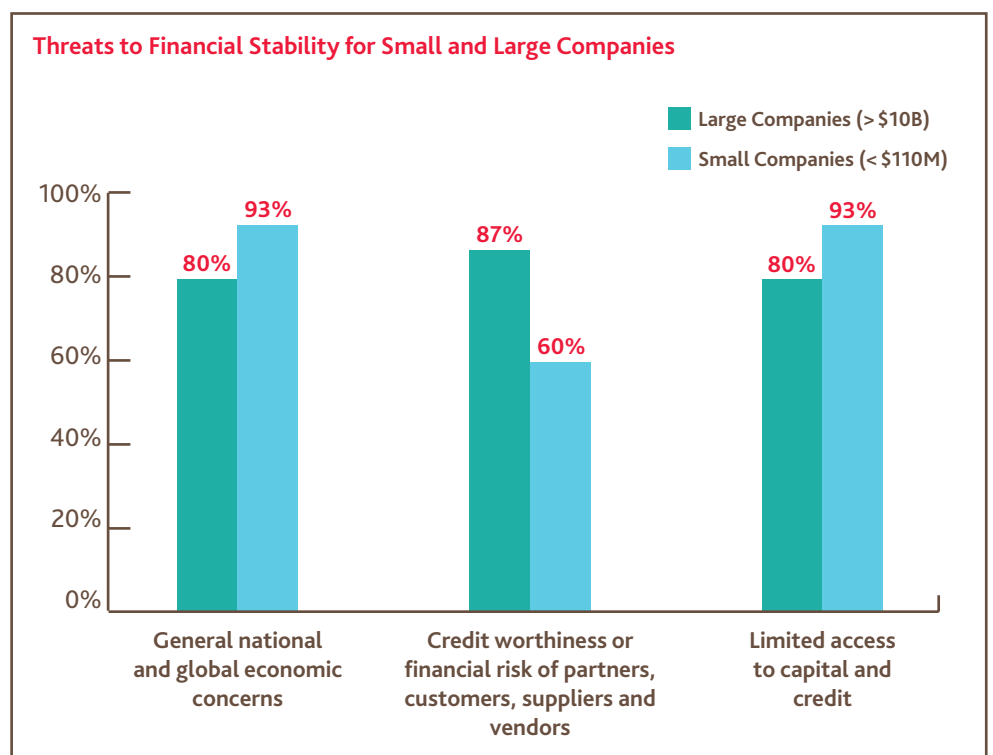
Inadequate liquidity, access to capital and indebtedness are among the top ten risks for companies (95%). The capital market is improving for the industry, but caution is being exercised as the economy remains shaky. The largest companies (with revenue above \$10 billion) are understandably more confident about their financial situation and the economy, with only 80 percent citing inadequate liquidity as a risk. More than half (56%) of CFOs reported their ability to access capital and credit is either the same or better than last year in the [2011 BDO Energy Outlook Survey](#). The general state of the economy also ranks high (#9) on the risk factor list, stated by 91 percent of companies. Again, this risk is lower for the largest companies, cited by only 80 percent.

▶ RIG SHORTAGES THREATEN TO DRIVE UP THE COST OF DRILLING

Drilling companies traditionally take a wait-and-see approach to anticipated demand for drilling activity, holding back equipment and causing rig prices to go up. “Shortages of rigs, equipment and personnel” was a risk noted by 72 percent of E&P companies, and the resulting increase in operating costs rounded out the top 20 list of risks at 67 percent. The study shows the largest companies holding more clout, with only 53 percent citing concerns over rig shortages and increased operating costs respectively. The smallest companies (revenues under \$110 million) feel these issues the hardest, with 93 percent citing increased operating costs as a top risk factor.

▶ LARGEST COMPANIES FOCUSED ON INTERNAL RISKS

When comparing risk factors by company size, the largest companies (revenues over \$10 billion) express less concern with external issues like industry competition and decreased demand, while these risks weigh heavily on smaller companies. Eighty-seven percent of small companies cite competition as a risk, compared to only 67 percent of large companies. Similarly, 93 percent of small companies are concerned over decreased demand of oil and gas, compared to 73 percent of large companies. Large companies are much more focused on internal issues. Eighty percent cite “the ability to attract or retain key personnel” as a top risk and 87 percent are concerned with properly executing their corporate strategy. These risks are less pronounced for smaller companies, cited by only 67 percent in both categories.



Top 20 Risks of the 100 Largest U.S. Oil and Gas Companies

2011 Rank	Risk Factor Cited in 10-K Filing	All Companies	Revenue >\$10 Bil.	Revenue <\$110 Mil.
1.	Volatile oil and gas prices	100%	100%	100%
1.t*	Regulatory and legislative changes and increased cost of compliance	100%	100%	100%
3.	Inability to expand reserves or find replacement reserves	98%	100%	100%
4.	Operational hazards including blowouts, spills and personal injury	97%	93%	100%
5.	Natural disasters and extreme weather conditions	96%	93%	93%
5t.	Inaccurate reserve estimates	96%	93%	100%
7.	Inadequate liquidity or access to capital, indebtedness	95%	80%	93%
8.	Environmental restrictions and regulations	94%	80%	100%
9.	U.S. general economic concerns	91%	80%	93%
10.	General industry competition	87%	67%	87%
10t.	Inadequate or unavailable insurance coverage	87%	67%	93%
12.	Reliance upon third-party transportation and processing facilities	83%	67%	80%
13.	Ability to attract or retain key personnel	78%	80%	67%
14.	Decrease in demand for oil or natural gas	76%	73%	93%
15.	Credit or financial risk of partners, customers, vendors or suppliers	75%	87%	60%
16.	Failure to properly execute corporate strategy	73%	87%	67%
17.	Competition from alternative energy sources	72%	67%	87%
17t.	Shortage of rigs, equipment and personnel	72%	53%	67%
19.	Impact of climate change and greenhouse gas legislation	69%	60%	53%
20.	Increased operating costs	67%	53%	93%

*t indicates a tie in the risk factor ranking

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