



SUMMARY – the collapse of the Canadian oil company Oilexco into administration after investing circa \$1.6bn since 2004 in the UK North Sea provides some important lessons for the sector. The failure of Oilexco is down to three main issues; lax financial and cost management, a weak board not capable of keeping a super-confident CEO in check and inadequate technical due diligence by the company and its lenders. The warning signs of lax financial management were there in the company reports and investors had confused frenetic activity with actual value creation. Oilexco preferred not to have partners so they could move quickly, so this important check and balance was absent. We believe the capabilities of independent directors on oil company boards should be strengthened and asset level disclosure of reserve estimates should be a requirement. The first would ensure better governance and the second would allow better independent evaluations.

Introduction

Oilexco's spectacular fall into bankruptcy and subsequent sale from administration to Premier Oil (subject to creditor approval) is by far the largest corporate failure in the oil sector in recent years. Oilexco had an enterprise value of \$4.2bn at end June 2008 and its equity was valued at over \$3.8bn. The \$505m sale proceeds are insufficient even to cover its ~\$560m debt, let alone its trade creditors, and the equity is worth nothing. The Oilexco saga has cast a shadow over the UK independent E&P sector.

How did it happen and what lessons can be learned from the debacle?

The Oilexco Business Model

Oilexco's model was to appraise and develop undeveloped discoveries in the UK North Sea. Its rise was spectacular. After entering the UK in 2002 from its Canadian base, it acquired a couple of licenses and appraised the Brenda discovery in early 2004 bringing it into production with Nicol in June 2007. It quickly became the most active driller in the North Sea completing ~111 wells up to the end of 3Q 2008. 86 of these wells were appraisal wells and Oilexco's modus operandi was to pepper a discovery with sidetrack well bores to delineate the accumulation. For example, the 5-10 mmbbl Shelley field had 22 well bores from 2 appraisal wells drilled into it prior to sanction. Oilexco's appraisal well failure rate was also very high, around 40%, and not much better than for a typical North Sea exploration well. Old North Sea hands would say this was not cost effective, even reckless, but Oilexco would argue that this was 'fast-track appraisal'.

A second element of the model was to operate as much as possible at the highest possible equity. The Brenda-Nicol and Shelley developments were both 100% owned projects. Consequently Oilexco's projects often did not have the checks and balances provided by partners.

Oilexco Governance

Looking at the profiles of the Oilexco board of directors on the company website it is noticeable that there is not a single mention of a mainstream oil company. Arthur Millholland was the founder and both President and CEO of the company which is contrary to best practice in board governance. Millholland has a reputation for super self confidence and was not noted for self doubt. The company head office was in



Canada with an operating base in Aberdeen and London. This was the apparent reason for the purchase of a corporate jet in January 2008



CEO Art Millholland on the steps of the now infamous corporate jet (photo and excerpt from Calgary Herald March 2008)

'The Challenger 605, a \$29-million 12-seater built in Canada and commissioned only a month ago, took off at 3 p.m. destined for Reykjavik, Iceland, and then onwards to its final landing point in London. The aircraft, one of just three Challenger 605s in operation, is 31.25 per cent-owned by Calgary-headquartered Oilexco Inc., a Canadian oil and gas explorer whose assets are based entirely in the U.K. North Sea. CEO Arthur Millholland travels to London and Aberdeen, Scotland, twice a month.

The plane's seats fold into berths, so it's possible to sleep comfortably, but just as important, Millholland said, is the fact company executives in the notoriously secretive oil and gas industry can carry on fulsome conversations about business without having to worry about who might be seated on the other side of the aisle.

Oilexco paid roughly \$9 million for its stake in the aircraft, the equivalent of about 250 hours of flying time annually, out of the company's 2008 capital budget.'

In retrospect, that the board approved such a purchase was symptomatic of a lack of financial management.

Financial Management

Oilexco achieved this frenetic activity by committing to two long-term rig contracts enabling it to both access opportunities and to drill them. By 3Q 2008 Oilexco's commitments under the drilling contract were \$550m of which \$250m was committed for the coming year and oil prices were plummeting. Oilexco's total contractual commitments by 2008 had grown to over \$1bn with \$450 due in the coming year. It invested a total of \$1.6bn since 2004 and had made \$0.4bn cash from production. Its cumulative cash flow at end 3Q 2008 was -\$1.2bn and it was still cash flow negative.

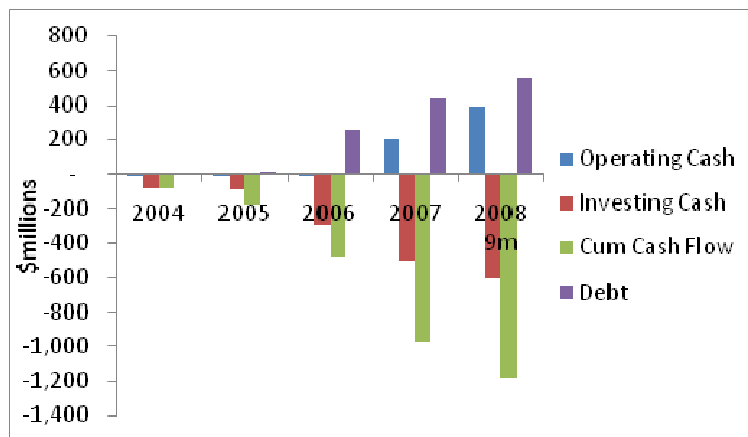


Figure 1 Oilexco cash flow and debt 2004 to 2008



Oilexco financed this activity through a series of share placings and debt financing through consortia led by the Royal Bank of Scotland. By September 2008 Oilexco had \$550m in debt (\$436m senior and \$129m pre-development) of which \$161 was repayable within the year. Oilexco announced plans to increase its debt facility to \$1bn in July 2008, but in the end the banks pulled the plug on Oilexco in December 2008.

Operational Performance

Oilexco's 2P reserves were estimated to be ~40mmbbl of which 22mmbbl were on production in March 2009¹. Note Oilexco's own auditor Sproule had estimated the 2P reserves to be 66mmbbl². The booked cost of these reserves was \$1.4bn giving a finding and development cost of \$35/bbl (DDA/bbl was \$36/bbl 20081h). With operating costs of \$12/bbl and G&A costs of \$14/bbl, the total cost per barrel of Oilexco's production was \$62/bbl³. Average North Sea development costs in 2008 would be around \$16/bbl⁴ and average G&A costs in Oilexco's peer group would be \$1-3/bbl.

Production from the Brenda-Nicol development was also disappointing as soon as it came on stream, well below the average 30mmbd expected during the first year.

The Shelley development for which Oilexco drilled four wells and committed to a five year \$350m FPSO contract is now considered uneconomic by Premier, who plans to abandon it if the contracts cannot be renegotiated.

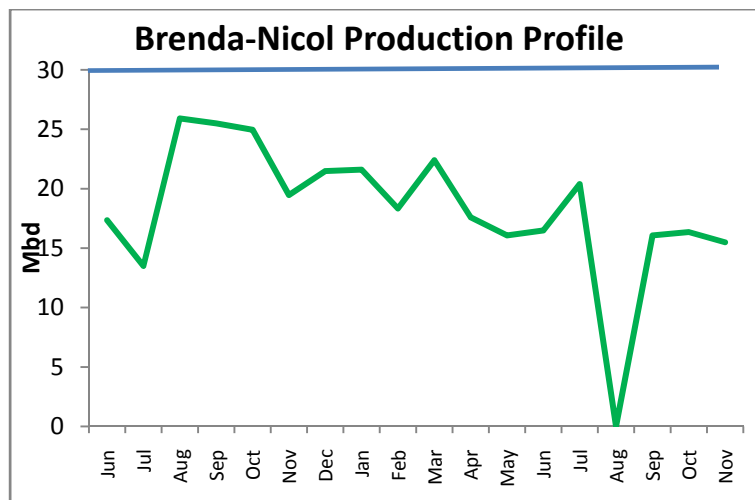


Figure 2 Production from the Brenda-Nicol Field from June 2007 to November 2008 (source BERR website)

So what went wrong?

Setting aside the oil price and the credit crunch the root causes of Oilexco's demise would seem to be

¹ By RISC consultants on behalf of Premier Oil

² Feb 13th 2009 Oilexco press release

³ By 2008 3Q this had risen to \$69/bbl

⁴ Source UKOOA



- A weak board with the lack of the key experience to challenge a strong willed CEO
- Inadequate technical due diligence, particularly reservoir engineering, both by the company and the lenders to the company
- A seeming complete lack of cost control with regard to drilling operations, developments and company overheads.
- A lack of financial risk management.
- Overexcited equity investors and equity analysts who blindly rewarded activity and news flow with higher and higher valuations.

What were the warning signals?

Oilexco was listed in Canada as well as in London and reported quarterly to Canadian standards. Consequently, its debt and contract obligations were laid out in a transparent manner and so it was not that the issues were hidden. It also reported reserves audited annually by an 'independent' Canadian consultant. Canadian reporting is much more transparent than in the UK, where reporting requirements are less strict.

We liked the Oilexco business model, we admired the ability to move quickly and we were bullish about their reserves and resources. However, in our last assessment of Oilexco in June 2008 we also noted the following -

- 'An impossible company to value due to insufficient asset level disclosure'
- 'High cost of appraisal drilling - \$38/bbl capex and opex'
- 'Oilexco is valued by the market at \$62/bbl at the extreme high end of the peer group'
- We were worried about Oilexco 'Drilling dumb holes just to use rig slots'

To this list we can now add

- Excessive G&A costs which had jumped to over \$14/bbl production
- Committing to contracts on the assumption that finance will be available

What are some Lessons Learned?

- If something looks too good to be true in the oil business – it is. The warning signs of lax financial management were there in the company reports.
- Suitably experienced, powerful independent directors are essential to keep overconfident CEOs in check.
- There is no substitute for thorough technical due diligence – check that it is in place and don't assume the banks will do it before they lend.
- High G&A costs are symptomatic of a lack of regard for cost management.
- Don't confuse activity with actual value creation.
- Check commitments are financed.
- Be wary of small companies going it alone – partners slow things up but give an extra layer of assurance. There is an old African saying – 'If you want to travel fast, go alone. If you want to go far, go accompanied'.

Recommendations

- Oil company boards should have independent directors with mainstream oil company experience able to verify financial management practice and technical due diligence.
- Smaller oil companies should be required to provide asset level reserves breakdowns.



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