Consultancy advice for YJ Oil & Gas

Suggested answers

Merits of a farm-out arrangement for YJ

1. Without a farm-out proposal for at least one of the new oil and gas fields, YJ would have a cash shortfall of US$ (150.0) million.
2. A farm-out arrangement shares the cost of test and production drilling, as instead of YJ having to finance total drilling costs of US$ 136.0 million for each of the three newly licensed oil and gas fields, YJ would receive 40% of the drilling costs at each of the fields farmed-out (US$ 54 million).
3. The farm-out proposal will give N or P 40% of all future oil and gas production but it will allow YJ to go into production sooner and not risk the possibility of not going into production before the licence expires at 30 September 2019 and possibly losing the licence.
4. Without one or more farm-out agreements YJ would not be able to finance the drilling at all three newly licensed oil and gas fields as this requires a total of US$ 408.0 million, which YJ does not have, even with a rights issue and some new loan finance, as these would together only generate US$ 90.0 million.

Which of the 2 farm-out proposals from either N or P is best suited to YJ's cash requirements:

5. The Chairman has stated that he wants to minimise the number of farm-out arrangements, and this can only be done by having a farm-out arrangement with N, as this generates a large up-front one-off fixed fee and is best suited to YJ's cash requirements.
6. YJ could accept the proposal to farm-out just ONE licensed oil and gas field with N, as this will generate a one-off fee of US$ 100.0 million plus the 40% share of drilling costs which equals US$ 54 million, which covers the forecast deficit of US$ 150 million.

Comments on the financial analysis of the farm-out proposals:

7. YJ needs to generate more than US$ 150 million in the next 2 years in order to bring all 3 newly licenced oil and gas fields into production and whilst the farm-out proposal from P generates more cash over a 10 year period and a higher NPV at US$ 129.6 million (compared to N of only US 90.1 million) it does NOT generate enough cash within the next 2 years if just ONE of the newly licenced fields were to be farmed-out.
8. If YJ were to select P, then it would need to farm-out TWO of the newly licenced fields, as each farm-out field would generate only US$ 98 million (based on 2 years at US$ 22 million plus share of drilling costs at US$ 54 million), therefore 2 fields would need to be farmed-out to generate in excess of the US$ 150 million deficit.

Recommendation

9. It is recommended that YJ farm-out just ONE oil and gas field and accept the proposal from N, which includes the one-off fee of $100.0 million plus a 40% share of drilling costs, totalling US$ 154 million.

Justification for the recommendation

10. By choosing just ONE oil and gas field to farm-out to N, this will generate a total of US$ 154 million, (US$ 100 farm-out fee plus US$ 54 m for N's 40% share of drilling costs), which just covers the forecast cash deficit of US$ 150 million, and this generates the much needed cash for YJ to bring all three oil and gas fields into production.