The upstream capital crunch:
Changing markets, changing dynamics
Introduction

There are more challenging times ahead for the oilfield services (OFS) sector, particularly those weighted towards the capex cycle. Whilst many, including Sir Ian Wood, think that the long term future of the United Kingdom Continental Shelf (UKCS) remains positive, with a “huge prize at stake”, changing market dynamics in the form of a reduced availability of capital, and the types of projects to be undertaken, present immediate challenges for OFS companies.

The past two years have proven to be both an interesting and challenging period for oil majors in their quest for reserve replacement. With their capital deployed drilling deeper and further afield, returns on projects have been compromised by budget over-runs and schedule delays. This has led the Majors to temper their capital spending ambitions and their shareholders to demand capital allocation strategy.

Therefore, we foresee that over the next two-to-three years the focus in the North Sea will move away from large-scale field development projects for the Majors to smaller asset maintenance and brownfield development opportunities and this could signify challenges, but also new growth prospects, for OFS companies in the UKCS in particular.

Chart 1: Share price performance of FTSE O&G producers and service companies

Shareholders have reacted to a series of profit warnings by oil and gas producers, with the sector tracking around 4% below its level at the start of the year compared to strong performance by the OFS sector. There has been a recent shift however as the market rewards strong messages issued on capital discipline.

Source: FTSE closing data, KPMG Analysis

The Exploration and Production (E&P) sector is feeling the impact of its recent capital spending overreach...

History has borne witness to the cyclicality of the E&P industry. The annual results announcements in early 2014 demonstrated that the E&P sector is entering a new phase of the cycle, where growth in capital spending, almost 230%, by the top 10 International Oil Companies (IOCs) between 2005 and 2012, plateaued.

Focusing our assessment on the UKCS market, we have analysed these changing industry dynamics to gain an understanding of the impact on the OFS sector.
Changing E&P dynamics means that UKCS OFS companies need to adapt or miss the opportunity...

Oil and Gas UK (OGUK), a leading industry body, estimates that investment in the North Sea hit a record high of £14.4bn in 2013, with a quarter of this cost attributed to four large developments operated by the Majors. However, OGUK expects this capex to halve over the next three years.

With high profile developments such as Rosebank (operated by Chevron) and Bressay (operated by Statoil) currently being labelled as uneconomic to proceed, the cost inflation issue has been clearly highlighted (see chart 3).

This adds to the troubles of the region, where production has declined by 38% over the past three years, as a result of reduced exploration drilling (see chart 4) and new projects proving to be smaller and more technically challenging than anticipated. Unless there are key changes made to current practices, we feel that there is a significant risk of further project cancellations, and as a result, considerable production declines as E&P companies tighten their belts and demonstrate increasing financial discipline.

In their efforts to boost free cash flow, the Majors and many IOCs have embarked upon significant portfolio optimisation drives. Many have announced major divestment programs.

As a consequence, we expect that the industry will continue to reassess its approach to cost and risk management over the next two-to-three years, shifting the focus of North Sea capital activity away from large-scale field development projects and towards smaller asset maintenance or brownfield development projects with a view to increasing reserves in existing assets. In the UK, the number of Brownfield developments increased from 24 in 2012 to 26 in 2013, and DECC also expects to see a further increase in investment in projects to promote increased and enhanced oil recovery.

This will require OFS companies to rethink their service offerings to the industry, which should favour the smaller niche players with specific areas of technical expertise and move away from larger, general purpose EPC contractors. This shift will also create downward pressure on oil service infrastructure prices in the near term. There is some evidence of this trend forming already, with global deepwater rig day rates starting to fall after several years of buoyancy. The strong historical correlation between rig rates and upstream capital costs would imply that other infrastructure development services provided by OFS companies will come under increasing downward price pressure.

Over time the North Sea supply chain has become more complex, with an increasing number of suppliers contributing to capex projects and opex services. We believe however, that cost pressures will drive M&A-driven consolidation of the supplier base as larger players seek to provide a wider offering to IOCs and NOCs at a reduced net cost.

### Chart 3: Average Reported Returns and Development Cost Escalation

![Chart 3: Average Reported Returns and Development Cost Escalation](chart3.png)

Cost increases are largely attributable to massive price inflation in raw materials and infrastructure. Pre-salt seismic imaging and deepwater drilling have allowed giant discoveries offshore, enhanced oil recovery (EOR) is maximising recovery factors globally, and massive LNG projects provide stable long term cashflow but deploying such costly technology comes at a price and is manifesting itself in a decreasing average returns trend for the majors.

#### Notes:
1. Unit costs representative of development costs as reported / reported production
2. Averages taken for BP, Chevron, ENI, ExxonMobil, Shell, Statoil, Statoil

Source: Woodmac, KPMG analysis

### Chart 4: UKCS exploration and appraisal drilling

![Chart 4: UKCS exploration and appraisal drilling](chart4.png)

A total of 52 E&A wells were drilled in the North Sea in 2013, representing a rise in exploration spending by £3bn in the year. However, this rise in drilling contrasted the £11.3bn increase in the previous year, and is driven from the pooling in exploration spending experienced by Oil and Gas UK, as reported by the Financial Times, required to maintain the rate of discoveries and keep production rates close to current levels in the next decade.

#### Notes:
1. Exploration wells
2. Appraisal wells

Source: Spends & Trends UKCS 2012-2016, Scottish Enterprise, Oil and Gas UK, The Financial Times
The National Oil Companies (NOCs) have widened their aspirations...

As the Majors re-allocate their capital, a number of National Oil Companies (NOCs) and Private Equity firms have sensed opportunity.

With seemingly enormous foreign resource targets, largely for security of supply purposes, their acquisition appetite has grown steadily. For the most part, the NOCs are cash rich, have a low cost of capital and are keen to develop their international presence and technical expertise.

Unconstrained by shareholder pressures and buttressed by the ambitions of their governments, they are able to deploy vast resources, often on high-risk assets, while holding a longer term view on expected returns.

Asian NOCs are now also starting to be concerned about portfolio management and consider potential divestments but this is with a view to maximise the performance of their portfolio, rather than to release cash to investors.

We would therefore deduce that the NOCs remain net acquirers whilst the IOCs remain net sellers in the near term. The NOCs are likely to fill the space left by the Majors, initially through traditional M&A and then later through increased exploration and associated project capital expenditure.

Generally new NOC entrants (provided they have sufficient capital strength) into the North Sea have been positive for activity levels, though more players can add to the complexity of operating arrangements, which is one of the key challenges which the Wood report identifies.

"Asian NOCs are now also starting to be concerned about portfolio management and consider potential divestments but this is with a view to maximise the performance of their portfolio, rather than to release cash to investors."
The NOCs offer a renewed source of profitability and growth for UKCS OFS companies...

In order to sustain their growth, service companies will need to follow the capital spending trail and adapt to doing more business directly with NOCs operating in international growth markets. This poses a series of challenges, though UK based OFS companies have demonstrated ability to do so in recent times.

UKCS focused service companies with day-rate agency staff based out of the UK will have to compete against global contractors operating with a lower employee cost base, unexposed to the movement of the British Pound Sterling in the international currency markets. In turn, this will mean that UKCS OFS companies will need to adopt a more competitive global business model.

Furthermore, OFS companies will have to engage in aggressive business development to be invited for pre-qualification for project bid lists and with that they may need to become accustomed to a highly procedural and prolonged procurement process. If they qualify, they will be asked to enter into lump sum contracts, having to assume additional execution risk.

They will also be required to adapt their delivery capability by incorporating local content into their materials and workforce. And of course, in addition to doing all of the above, they must obviously continue to deliver on the growth expectations of their shareholders.

As the IOCs experience pressure to improve their return on capital and test their abilities to effectively and efficiently build the infrastructure required to bring their reserves to market, the era of the newly confident NOC consolidating its control over its vast hydrocarbon endowment has been ushered in.

Looking ahead...

We think that in order for the UKCS OFS companies to prove to their investors that they can continue to generate returns in the face of this threat, some fundamental rethinking of their product offerings and realignment of market priorities will be required. Notably, OFS companies must focus on three key areas:

1. Re-evaluate the scalability of their operating model to new markets and operating conditions
2. Renew their focus on cost control and optimisation in the face of lower cost Asian competitors
3. Re-visit their approach to contracting, with a view to assuming greater levels of execution risk

The companies that are able to achieve this will be best placed to manage risk and build an organisation geared towards shareholder growth. Most importantly, they will be able to navigate through this uneasy period of the E&P cycle and find themselves on top as the industry enters its next phase.

“Capital investment in the North Sea is set to half from record highs set in 2013 – change is needed.”
Recognising the effect of declining investment and production within the United Kingdom Continental Shelf (UKCS) on tax revenues, the Government in June 2013 commissioned Sir Ian Wood, the former Chairman of the Wood Group, to provide recommendations on maximising the production of the remaining recoverable hydrocarbons in the UKCS.

This was the first review of its kind for two decades. In February 2014, Sir Wood delivered a set of proposals that was well received by the industry, with engagement from DECC, HM Treasury and senior Government Ministers.

The Wood report addressed challenges of aging infrastructure, skills and resources, emphasising the need to align the commercial interests of individual producers with the aim of maximising economic recovery for the overall benefit of the country. While condoning the licensing model which governs the transfer of economic benefit from the UK’s oil and gas resources to the government, the report called for greater collaboration between the government and industry by the creation of a new ‘arms-length’ regulator.

The report also focused on the potential for greater collaboration within the industry itself through infrastructure sharing and the development of regional hubs. In a further display of fresh thinking around the UKCS, the report called for the development of sector strategies jointly by the new regulator and the industry in areas such as exploration, improved oil recovery and decommissioning, which, once established, will be binding upon the industry.

Of equal importance to the new ideas recommended in the report is the reaction of the Government. By laying out the potential of a £200 billion boost (at today’s prices) to the UK economy over the next 20 years, Sir Iain has ensured that the Government will sit up and take notice. There are hopes that future tax breaks are to follow to encourage the industry to tap this potential, similar to the decommissioning relief introduced in October 2013 and estimated by the Government to be worth up to £20 billion. Indeed, the government has already begun to implement some of the report’s recommendations through the establishment of a new stewardship authority, the Oil and Gas Authority, in June 2014, and calling for an open consultation on the UKCS oil and gas fiscal regime in July 2014.

The OFS sector, in particular, is buoyed by the prospect of improved capital activity arising out of Sir Wood’s call for investment in key infrastructure, as well as a regional strategy emphasising shared exploration and decommissioning activities across clusters of fields.

Will the Wood report be the North Sea’s saviour? Early signs are positive. As a new, stronger regulator is established and the industry begins to joins hands with the government to formulate and establish sector strategies aimed at maximising recovery, the markets should no doubt take notice and build the expectation of future increases in profitability into share prices. HM Treasury will obviously also benefit from improved recovery.

But for recovery to be maximised, a significant change to the ways of doing business is required. The operating model in the UKCS has remained largely unchanged for decades. A fundamental shake-up of the status quo, as advocated by the Wood report, still has many unanswered questions about just how the recommendations will be implemented; how the industry will develop the skills required; how will the regulator be funded, and what additional incentives will the industry require to encourage collaboration whilst ensuring the UK remains competitive relative to other international investment options?

Thanks to the Wood report, OFS companies are right to look to the future with hope. However, they must find a way to address the challenges that lie before them.

Sir Ian said the changes would add “at least” £200bn to the UK economy over the next 20 years.
Contact us

Emma Wild
Head of Upstream Advisory
KPMG in the UK
T: + 44 (0) 20 7311 6008
E: emma.j.wild@kpmg.co.uk

Alan Kennedy
Oilfield Services Lead Partner
KPMG in the UK
T: + 44 (0) 1224 416881
E: alan.kennedy@kpmg.co.uk

Arif Kamruddin
Associate Director
KPMG in the UK
T: + 44 (0) 20 73111360
E: arif.kamruddin@kpmg.co.uk

kpmg.com/uk/oilandgas

For further insights on the oilfield services sector, look out for Focus on Oil & Gas: Oilfield Services edition.

Coming this Winter 2014