Staying afloat in the perfect storm: how offshore drillers are adjusting to changing environment

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THE PLAYERS IN the offshore drilling market are still adjusting to the dramatic changes of the past nine months. The interrelated global recession, credit crunch, decline in oil and gas consumption and, most importantly, precipitous fall in oil and gas prices have sent the industry’s planners back to their drawing boards to rewrite their long-term and, in some cases, short-term strategies.

For operators, the questions that must be addressed are likely to include:

- “Which projects should continue as originally planned?”
- “Which projects are still viable at expected oil and gas prices but need to be retimed to match our cash availability?”
- “Which projects should be postponed until we have confidence that oil and gas prices will move to, and stay in, a higher price band than we can reasonably expect today?”
- “How will supplier and service company prices change and how will this affect the economics of my planned projects?”

For drilling contractors, questions may be along the lines of:

- “Do I have the funding in place to complete my newbuilding program as planned, and, if not, what are my options?”
- “How firm is my contracted backlog?”
- “Is this the time to acquire some existing and/or under-construction rigs at bargain prices?”
- “Is this the time to acquire or be acquired by a competitor?”
- “To what extent will we find ourselves in the coming years competing with customers who are offering sublets on their rigs?”

Even in the unlikely event that oil and gas prices stop fluctuating – at the time of writing, NYMEX oil futures have moved up to the low USD $50s per barrel – it will clearly take some time for operators and contractors to work through these and other issues. Meanwhile, the usual unknowns associated with the results of exploration and appraisal drilling mean that any plans are just that, and are likely to need constant revisions.

Against this dynamic background, while it may be a little early to try to predict where things are going, it is still interesting to step back a little from the day-to-day news and review what has happened lately and what trends may be emerging in the offshore drilling market.

Perhaps surprisingly, given the long run-up in oil prices, actual rig activity, as measured by working rigs, has changed comparatively slowly over the past few years. It took more than five years for the total to rise by 100 rigs from 466 in January 2003 to a peak of 589 in July 2008.

While the main rig types have generally high levels of utilization, the niche markets, with the exception of tender-assists, are exhibiting a considerable degree of oversupply, although the numbers of rigs in each of these segments are small.

With activity apparently on the decline, a worrying feature of the outlook, not only for drilling contractors but also for operators whose revised plans mean that they now have more rig time contracted than they expect to use, is the number of rigs still under construction and on order. All of these are currently scheduled for delivery by the end of 2012.

Many of these rigs have no contracts, and their imminent arrival is indirectly putting more downward pressure on dayrates as a further decline in utilization is expected when these rigs become available on delivery from shipyards.

Figure 1: The number of working rigs has changed comparatively slowly over the past few years. It took more than five years for the total to rise by 100 rigs from 466 in January 2003 to a peak of 589 in July 2008.
Even when oil prices were still climbing, there were concerns that too many jackups were being built. Now it is clear that the market will be significantly oversupplied unless wholesale retirements take place. Of course, as the recent past has shown, you can retire a rig, but that doesn’t mean it won’t return to the fleet at a later date.

Even rigs that have been so severely damaged by accidents or hurricanes that they have been declared total losses for insurance purposes, have subsequently been rebuilt.

Unless a rig is cut up for scrap or is deliberately scuttled, there is no guarantee that it will not be reactivated.

The situation is very different for floaters. All of the uncontracted semisubs and drillships, other than the multipurpose Island Innovator, are ultra-deepwater vessels and will therefore be looking for work in the market segment that has been least affected by the recent turmoil. However, even here all is not necessarily well because the long contracts that have been a feature of this segment do have something of a potential downside.

Unless an operator has an extensive development program that will be performed regardless of the gyrations of oil prices, it is unrealistic to plan all of the work corresponding to a multi-year contract before the contract has started. This is especially true if the rig concerned is a deepwater one and was ordered on the basis of the contract in question. This means there will be a lag of three years or more between the date of the contract signing and the date that the rig starts working. In the tight market that was seen as inevitable until recently, operators could have reasonably expected that any surplus time would be welcomed by other operators who had not planned far enough ahead in terms of contracting a rig.

As alluded to above, we are now seeing gaps appearing in programs for all rig types, including deepwater and ultra-deepwater units. Until a few months ago, there had been a growing business in subletting from one operator to another. Figure 4 shows the number of rigs that have been operating under sublets since the beginning of 2000.

The flurry of activity for floaters at the beginning of this period corresponds to the time when the last batch of deepwater rigs joined the fleet. During that building boom, almost all the new rigs were ordered on the basis of a contract because it was, for all practical purposes, the only way to get hold of a deepwater rig at the time. Therefore, the rigs were virtually all on multi-year contracts.

The deepwater market was still in its relative infancy, and it soon became apparent that many operators had insufficient work – in any water depth – to keep these rigs busy. So the sublet market blossomed.

Such was the degree of oversupply that operators were forced to discount the rates they were paying when fixing these sublets. They were finding themselves competing with drilling contractors who had available units and were prepared to offer these at rates considerably lower than they, the operators, were paying.

The recent decline in the volume of sublet activity may be a sign that, in today’s market, operators with surplus deepwa-
ter rig time are standing firm and refusing to sublet their rigs for less than they are paying. Meanwhile, companies who have an immediate use for these rigs are waiting until someone breaks ranks, and most contractors have few, if any, deepwater rigs to offer in the near term. They are, therefore, under little pressure to contract rigs at rates below the levels that have prevailed over the past couple of years. Still, there may be instances where contractors need to sign contracts by specified dates to satisfy the terms of their loan agreements, and this could lead to lower dayrates.

With only six new fixture dayrates in the last four months for rigs with rated water depths of 5,000 ft or more, it would be dangerous to read too much into the apparent downward trend shown in Figure 5. In particular, the two recent fixtures for rigs with rated water depths in the 5,000-ft to 7,499-ft range around $370,000/day are both for one-well contracts and probably not representative of the broader market.

Clearly, a decline in dayrates would be welcome news for operators and should eventually lead to an increase in demand for rigs. This, in conjunction with falling prices for other goods and services, would improve the economics of all exploration and production work, regardless of what happens to oil and gas prices. However, although drilling contractors have been making record profits, several – particularly the new entrants who are entirely dependent on new rigs for their livelihood – are experiencing financial difficulties. There are limits to how far they can drop dayrates and stay solvent.

Recently, financing for one deepwater semisubmersible could not be completed – a shock to most observers. The company had negotiated a contract with Petrobras for the rig that involved a firm period of six years. Given Petrobras’ appetite for deepwater rigs, this should’ve been a very low-risk project.

Another factor limiting the extent to which dayrates can fall while allowing contractors an adequate profit margin is the increasing level of rig-operating costs. Although these tend to vary greatly from month to month for any given rig, they have been rising fairly dramatically in recent years for all rig types in all regions. The underlying causes include a shortage of experienced and qualified offshore personnel in an environment where all companies are seeking crews for their new rigs; a rise in insurance...
costs that reflect increasing rig values and the losses sustained by insurers due to hurricanes in the US Gulf; and higher costs for all types of parts and materials.

Figure 6 shows an estimate by ODS-Petrodata of how costs of operating a semisubmersible have risen over the past 15 years on an indexed basis. These exclude the costs associated with yard stays, which are typically higher than those incurred during normal operations.

While the movement in actual costs for individual rigs and specific companies will be different from those shown here, most contractors are likely to have seen their operating costs more than double since 2000. The larger contractors enjoy economies of scale when ordering parts and can redeploy personnel to working rigs when units are taken out of action, which allows them to contain crew costs. Yet smaller companies usually do not enjoy such luxury. It is probably an extreme example, but, according to a recent stock exchange filing, the operating expenses in 2008 for one of the smaller deepwater contractors topped USD $180,000 per day per rig.

At the same time, the huge backlogs and correspondingly strong financial position of the established contractors – in particular those with limited newbuilding programs – provides the wherewithal to snap up smaller competitors. It is virtually inevitable that we will see more consolidation of the industry in the next two to three years. This could take the form of taking over the management of rigs, both existing and under construction, acquiring specific newbuild projects where financing is a problem for the current owner, or buying entire companies.

With around 100 companies in the offshore rig business, some reduction in the number of palters would make sense from an industrywide perspective as it would create more economies of scale, stronger participants and better opportunities to train and develop the workforce.

In summary the offshore drilling industry is likely to emerge from this period of change as a leaner and more efficient industry, although some companies will inevitably fail to make it while others will seize opportunities to strengthen their positions – and market shares.

Tom Kellock is head of consulting & research – Houston for ODS-Petrodata. He will be making a presentation, “What Next for the Offshore Rig Markets?”, at the IADC World Drilling 2009 Conference & Exhibition, 17-18 June, in Dublin.