A PROJECT FOR UPSTREAM SERVICE INDUSTRY WITH (ONLY) 5 MILLION USD

By Tankut Yildirim – tyildirim@tpao.gov.tr

In this essay I will try to clarify a project framework for upstream service sector. In this context the evolution of upstream service industry will be summarized. Then an “informal project proposal” or an intention will be the question in low oil price environment. Following the summary of project proposal constrains strong points and short and long term expectations and impacts will be discussed.

Oil industry is a capital-intensive industry. When risks are ignored, they cause serious problems for oil companies. As a result companies imitate best practices from each other and even from different industries for risk mitigation. One of the most accepted organization model for oil companies have been vertical integrated model. This model refers that an oil company should include all value chain in its bodies. Because for instance upstream activities contain high risk and downstream activities contain less risks and creates more cash flow for companies. In refining companies seek to benefit from margins in markets to get more income in refining business. All parts of the value chain have their own risks and rewards.

Since 2004 with the rise of oil prices companies started to explore more expensive resources and produce expensive oil. The level of activity in industry increased dramatically and companies started to use service companies more often in their activities. Actually the trend started in 90’s that time oil companies drilled most of their wells via in-house drilling. However more challenging oil resource become more attractive and service companies have high-skilled work force and it is proved that service companies are more efficient in drilling process. As a result oil companies started to use service companies in their activities. This also gave vertically integrated oil companies a different chance: if they have good prospects in challenging geographies they did not have to employ too many staff, because service companies with high expertise and skilled labor force were ready for service of oil companies. Vertically integrated IOC’s have high expertise and skilled labor however not all companies are well established as IOC’s.

In 2000’s level of in-house drilling decreased dramatically. It may be called as dolce vita for service companies. They acquired huge incomes until 2015. The value of assets show that the asset value of service companies increased much more faster than IOC’s. IOC’s have focused mainly on expensive oil sources and service companies have got a lot of income by joining the drilling operations of IOCs.

As it is said, until 2015, service companies had important amount of income. When oil prices started to decline in the last quarter of 2014 major oil companies came together and discussed the new low price environment. One of the most important remarks from one of these meetings was expressed by the CEO of ENI: “In 90’s oil companies also managed drilling operations via in-house drilling, in last years margins for oil field services increased dramatically and they can not be sustained in low-oil price environment, oil field service companies should discount the service prices.” Following these remarks IOCs started to cancel their expensive projects. The victim of the process have become oil field service companies.

Oil field service companies were well aware of the risks of their business. In this context some of them like Technip integrated their activities with other operations of upstream industry. In other
words, they did not limit themselves with only drilling operations and they started to produce oil. That organization type also brings more profit to company.

Still it can be claimed that oil field services could not recover from a crisis caused by oil prices. Cost of oil field services decreased 30% worldwide and in Russia due to sanctions and currency depreciation the fall is much more steep. The process also causes unemployment and decrease of corporate values of service companies. Some of the financially strong companies assess that it is the best time for an acquisition.

Honestly 5 million USD is not a big amount of money for oil industry. However a service company can not be cheaper than today due to low oil prices. A small oil field company can be bought with this money especially in US or Russia.

The project idea can be summarized as follows: If an industry player (oil field service company) is able to standardize its needs for operations, then it can bargain with small equipment producers (with certain quality certificates). The aim of the bargaining process is to convince equipment producer for mass production instead of production by orders. Cost of production of equipments will be a matter of scale of economics. Cost of equipments will decrease seriously and this will give the service company that uses standard equipments in its activities a cost advantage in comparison with its competitors. In other words the company that uses standard equipments will have more strong against low oil prices. Low cost of operation can be a way to eliminate competitors in the market in longer term.

It can be claimed that a company worth 5 million (including equipments) can not dominate market and force equipment producers for mass production and to hold stocks (when they are not able to sell the rest of equipments). However important amount of players may convince an equipment producer (This option is evaluated for US market in the next paragraph). So that the producer may be sure about security of demand to some extend. Then the company with 5 million $ value should clearly define its target market. The target market should be less developed in terms of organization model. In other words, the company should take the advantage of its business model in external markets where other players suffer from high costs / low oil prices. The issue to choose the target market will be a matter of finding the country with high risk and high reward. While taking investment decision, the company should also take regulations (like customs regulations) into consideration in target markets not to face barriers (for instance if drilling equipment has immunity from taxes this will be an advantage for the company).

It is also possible to think the model in major countries with strong service sector and try to estimate possible results. For instance in U.S. cost of services decreased dramatically although cost of unconventional oil is higher than cost of onshore conventional oil. Service sector players should cooperate not to go bankrupt so that they can convince equipment producers for certain standards and mass production. Currently there are a lot of companies for sale in U.S. due to competition in US drilling market.

More suitable example can be the Russian drilling market. Market shares are concentrated between very few companies. However due to depreciation of rouble, companies lost value and became cheaper. In addition to that Russian oil field services market has a different organization type in comparison with other drilling markets. For instance western companies make contracts for each
work (unit) however Russian business model is a turn-key model, when a service company starts to work in an oil field, it does all the work for a fixed price. Besides economic situation in Russia, the structure of the Russian model makes the oil field services (for onshore oil fields) cheaper. Also Russian service companies use Russian equipments. For a Russian service company the first step can be working with the current structure in (onshore) oil producing countries (with high risk/reward) by sustaining the same quality with western companies which is an important problem for Russian companies. If best practices in terms of operational excellence are sustained in company, then new ventures can be managed in focused regions. The following step will be standardization of equipments which will decrease the cost of services for the Russian company. There is also another important incentive for Russian drilling companies. To mitigate the impact of sanctions tax rates for oil companies are very low and Russian government supports development of domestic equipment industry especially for offshore and Arctic technology.

To sum up it is a good time to acquire a service company in Russia. The market is divided among important players. However costs are lower (in rouble) and in international markets (income in USD), usage of Russian equipments provides serious cost advantage. In addition to that in longer term if standardization of equipment is achieved for certain materials, another cost advantage will become visible.

In terms of impacts of standard usage of some equipments can be summarized for short term as follows: First and foremost, in short term it can be problematic to fix costs and standards for equipment producers, however when the regulations for these issues are set, then it will create cost advantages for companies in comparison with other conventional drilling companies. Probably onshore conventional oil equipments can be standardized easier than other challenging oil sources. Also it is impossible to standardize all equipments. However a success will give an important competitive advantage for successful company that makes that kind of R&D a risk that may be taken depending on risk appetite.

Global oil field service industry faces serious profit problem and it shrinks at the moment. Mergers and acquisitions will be more visible if oil prices continue for some time, in short term an investment can be regarded not so lucrative however with adoption of western standards and business opportunities outside of Russia can provide a company more advantageous conditions. A company that spends in rouble and earns in dollar can survive in short run, for further consolidation equipment standardization can be a way as it is mentioned before.

In longer term cost reduction will have a more visible impact and it will shape market strategies. In this context if the initiative triggers some improvements in offshore industry then it will be easier and cheaper to produce offshore resources.

Major risks can be the following issues: lack of rule of law, disadvantageous/selective implementation of rules against small companies, corruption. In addition to that the relations between Turkey and Russia worsen due to sensitive issues in Syria. However in normal times it is not easy to invest 5 million USD and make an important return. In other words, high risks are making the Russian market attractive.