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Back-to-basics approach can bring profits back to oilfield services

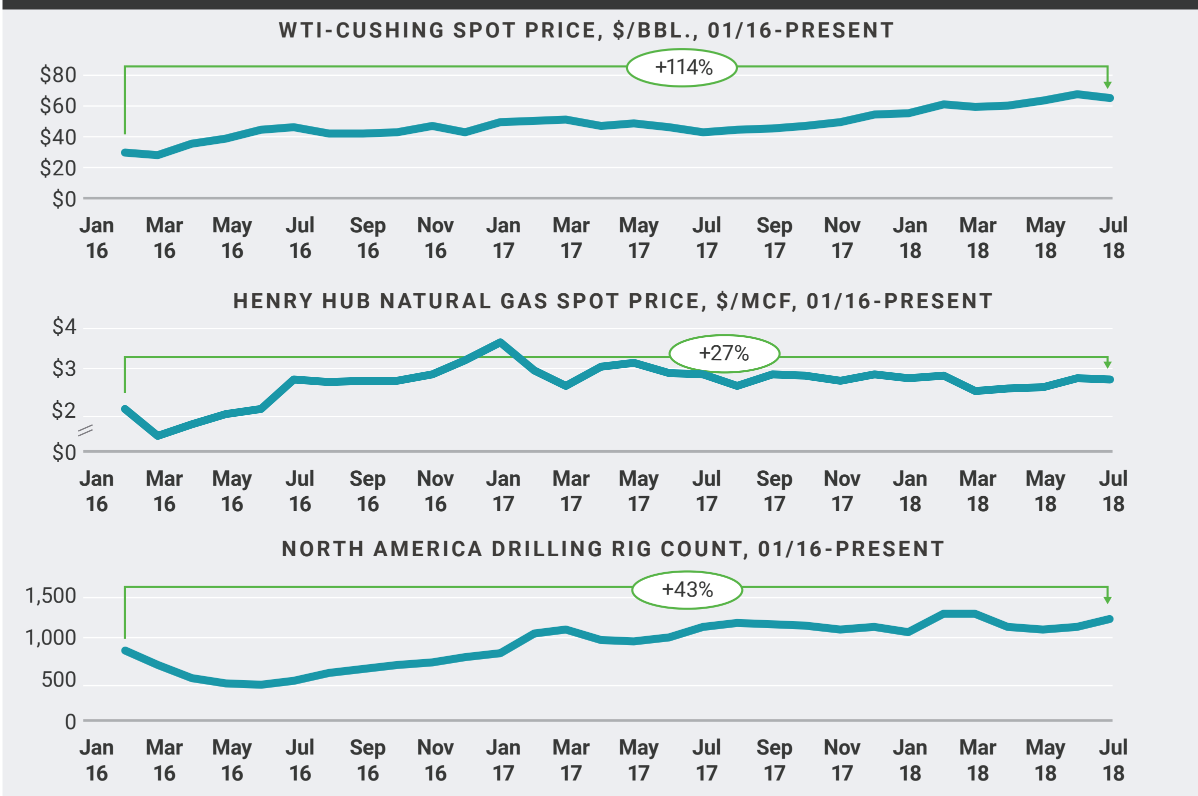
The Oilfield Services and Equipment (OFSE) sector has traditionally been a critical partner to Exploration & Production (E&P) companies in the upstream oil and gas sector. Not only do these companies provide the services and equipment to efficiently develop and produce reserves, they have also been key innovators of new products and services. However, despite the latest uptrend in oil prices, many OFSE companies remain sidelined when it comes to profitability.

Since the beginning of 2016, crude prices have been on the climb, and as expected, industry activity has picked up as well. The North America drilling rig count is above a healthy 1,200, re-hiring is in full swing, and overall demand for oilfield services and equipment is rebounding (see figure 1). But while business has improved pan-industry and most metrics have trended up, profits are still hard to come by for the OFSE sector.

WHO IS BENEFITTING FROM THE PRICE RISE?

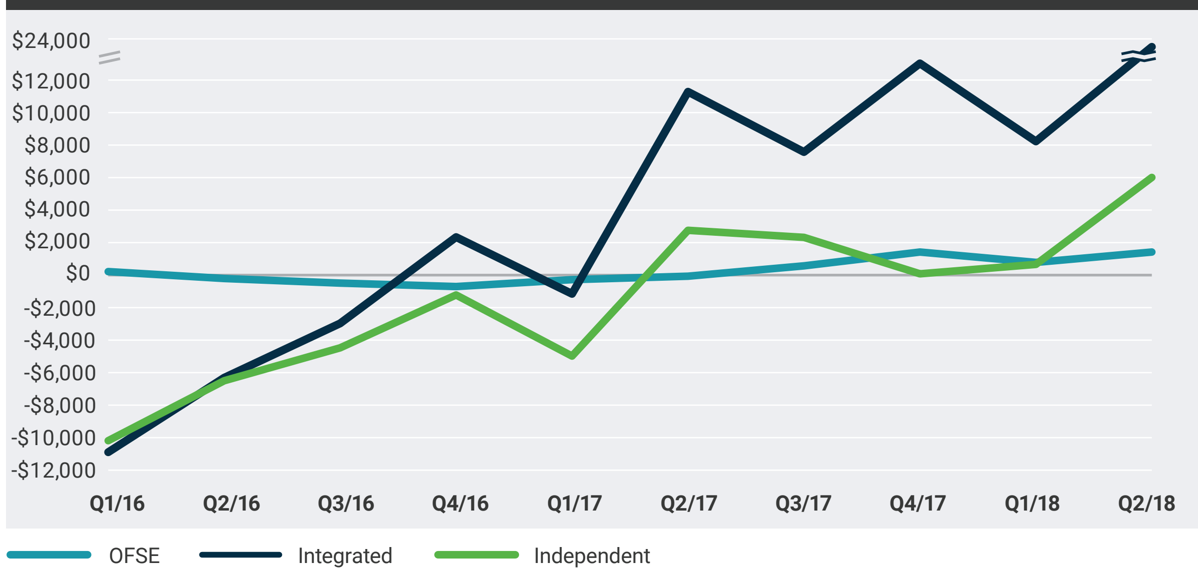
Over the last 2 ½ years, profits have rebounded nicely for most E&P companies. The Integrated majors – which participate across the entire oil and natural gas value chains – are reaping the benefits of their cost-reduction initiatives during the downturn, the inherent quality and productivity of their asset base, and the payoff from long-cycle projects that were initiated many years ago. Independents, which typically only explore and produce, are also seeing a strong return to profitability (see figure 2). However, profits remain roughly flat for the OFSE sector. Investors have noticed, too, as returns to shareholders from Integrated and E&P players have far surpassed those from the OFSE sector (see figure 3).

FIGURE 1: COMMODITY PRICE & RIG COUNT TRENDS, 01/16-PRESENT



Source: CapitalIQ, EIA, DrillingInfo, 2016-Present; AlixPartners analysis

FIGURE 2: OPERATING PROFIT TRENDS BY PLAYER CLASS, $ MILLION, SELECT COMPANIES, 01/16-PRESENT



Source: CapitalIQ, 2016-Present; AlixPartners analysis

FIGURE 3: TOTAL SHAREHOLDER RETURNS BY PLAYER CLASS, SELECT COMPANIES, 01/16-PRESENT

Source: CapitalIQ, 2016-Present; AlixPartners analysis

WHY IS THE OFSE SECTOR LAGGING?

There are several factors at work contributing to the Integrated and E&P sectors seeing profits in a much higher range as compared to OFSE companies:

1. **Supply chain management:** E&P companies negotiated hard with equipment and service providers during the downturn to reduce their own costs, and now, pressured to show returns to investors, are resisting price increases for as long as possible.

2. **Improving project design:** E&P players are increasingly leaning toward standardized well and pad designs, which enable them to drive more volume and lower prices, particularly when it comes to equipment.

3. **Continued offshore weakness:** Offshore-oriented OFSE companies and those with a mixed onshore-offshore footprint are still grappling with the lack of demand and a slower recovery in offshore spending.

4. **Vertical integration in industry:** E&P companies have vertically integrated into high-return, low-complexity categories, such as procuring sand and managing water logistics. OFSE players previously dominated these areas and generally passed markups onto the E&Ps.

5. **Concentration of activity:** The significant concentration of activity and spending in the Permian Basin has created hyper-competitive pricing and increased costs of labor and other resources. A muted recovery internationally and in other domestic basins has compounded this effect.

6. **Oversupply:** The WTI discount on Permian crude is currently capping capital spending activity in the basin. This is expected to last until the end of 2019, when new pipelines should increase the capacity to take crude out of the Permian and bolster rates of return for E&P companies. At the same time, the entrance of PE-backed OFSE players has resulted in over-capacity in some segments of the market, which is helping keep a lid on pricing. These new players have added capacity in key areas, such as hydraulic fracturing, coiled tubing, perforating, and water management. This means that E&P players have more choices than ever, and, as a result, can aggressively play off OFSE companies on price.

FIGURE 4: INDEPENDENT E&P OPERATING PROFIT RESULTS VERSUS COMMODITY PRICE, SELECT COMPANIES, 01/13-PRESENT

Source: CapitalIQ, EIA, 2016-Present; AlixPartners analysis
Note: Operating Profit is calculated as the weighted average of the top 20 independent North American E&Ps by revenue

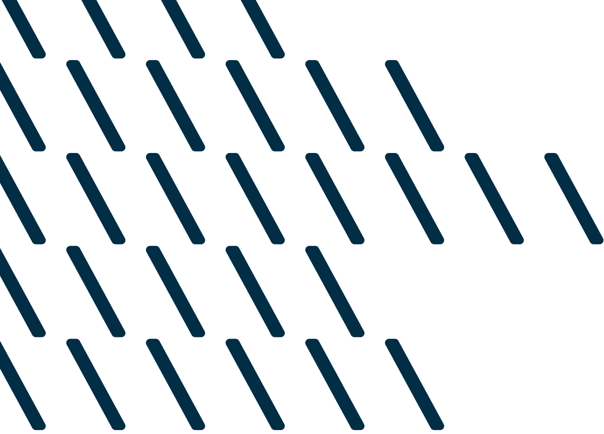
Historically, E&Ps have been heavily dependent on the OFSE sector to execute many aspects of the field lifecycle, including exploration, appraisal, commercial development, production, and abandonment phases. As the industry cycled between low and high commodity price environments, the OFSE sector was very astute at capturing much of the excess “rent” during periods of high oil prices. Led by the larger, diversified OFSE companies, prices for equipment and services were raised to the point that returns for E&P players were effectively capped. It appears that now the E&Ps have flipped the table and are increasingly becoming smarter at managing their suppliers. As evidenced, the operating profit margin of the E&P sector was identical in 2014 when oil prices were $100/bbl. to present day, when oil prices are at approximately $65/bbl. (see figure 4).

WILL OFSE PROFITS CATCH UP?

In the short term, the muted market recovery may create a challenging pricing environment. In the medium term, OFSE profits will likely catch up, as oilfield capacity becomes more balanced with E&P demand. In the interim, companies that deliver differentiated returns will be the ones that are able to make smart, but simple adjustments and return to business basics. In short, they could pursue many of the strategies that their customers have also deployed. These include:

1. **Pricing/utilization optimization:** Traditional pricing for oil field jobs has used a cost-plus approach, in which OFSE players apply a relatively fixed mark-up percentage to their E&P customers. While this approach ensures that each individual job is profitable, it fails to fully consider the effect of utilization on total field-level profitability. OFSE players can more effectively balance the trade-off between utilization (a full calendar) and pricing (job margins). This approach focuses on covering and then exceeding core drilling, frac, or service crew personnel and maintenance costs, which are relatively constant over time. With an empty calendar, OFSE companies can price jobs at near breakeven margins, and combined with excellent delivery, improve overall profitability. Conversely, with a nearly full calendar, remaining capacity becomes rare, and as a result can be priced to capture excess rent at a premium above historical margins.

2. **Excellence in procurement:** Like their E&P customers, OFSE companies negotiated hard with their suppliers during the downturn. However, not all OFSE players sought to manage risk and reduce complexity in the process, which can help sustain price negotiations through the recovery. There is incremental opportunity to standardize specifications across field locations and negotiate scaled agreements for categories such as



Digital is an opportunity both to lower costs and to create differentiated offerings and improved pricing.

chemicals, lubricants, and rental equipment. Additionally, OFSE companies can vertically integrate with suppliers of key categories, such as sand, water, and drilling mud, to ensure supply availability at competitive pricing. Companies without the scale to vertically integrate have opportunities to outsource management of these to third-party sourcing, storage, and logistics firms to manage end-to-end category procurement.

3 **Efficient labor management:** Despite widespread concerns over oilfield labor costs, research indicates that hourly non-supervisory oilfield service wages have risen by less than 10% since 2014. Consequently, there are opportunities to improve both labor efficiency and effectiveness. Tracking daily employee time, monitoring overtime, comparing efficiency across crews, and balancing full-time and temporary labor are all areas to improve labor efficiency. Conversely, there is additional opportunity to pay crews more if they hit performance-related targets (feet per day, stages per day, gallons per day, etc.). Companies that have the right metrics and targets in place, combined with uncapped bonus structures, could become the preferred employers for top oilfield talent.

4 **Operational excellence:** Research indicates that while drilling and completion days for comparable wells have decreased by 30-40% over the past five years, not all OFSE companies have visibility into real-time crew performance. In fact, many companies continue to track whether their assets were working at all on a given day, rather than the performance or effectiveness of those assets. By tracking asset performance, such as feet per day (drilling), stages per day (frac), gallons per day (water management), and feet of tubing installed per day (coil), OFSE companies can compare performance across crews using a standard activity metric. By overdelivering, crews can improve utilization and profitability without increasing the asset base. For example, some Permian frac operators have achieved more than seven stages completed per day, compared to the industry average of five stages. For a typical well, this can lower job durations by nearly 30%.

5 **Digitalization initiatives to drive efficiency and differentiation:** Digital is an opportunity both to lower costs and to create differentiated offerings and improved pricing. On the cost side, there are opportunities to improve the use of sensors on key assets (pumps, drilling rigs, blenders) with the goal of improving safety. This would also mean that crew members can focus on managing exceptions rather than manually monitoring equipment. Real-time request systems can automate the dispatch and routing process for bulk logistics trucks carrying sand or water by connecting E&P service requests to local OFSE companies at negotiated rates and through automated ticketed and billing processes. Smart devices can be used by crews to improve the use of daily labor billing and electronic ticketing, thereby reducing paper-based invoicing. Real-time analytics can also be used to generate up-to-the-minute operating and profitability visibility by job, truck, or customer. OFSE companies can also follow the example set by automated drilling rigs to apply similar algorithms for completion and well service equipment to reduce crewing requirements.

LOOKING TO THE FUTURE

E&P companies appear to be in the driver's seat with respect to generating profits for now. However, OFSE players should continue to adjust and refine their business models and operating practices to enable the industry to return to an equilibrium. Pursuing all avenues of optimization could help the OFSE sector capture their fair share of the industry profit pool. After all, generating a sufficient level of profitability is what will enable reinvestment and further technology development, thus continuing the important role of the OFSE sector in driving innovation in the industry. **A**

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