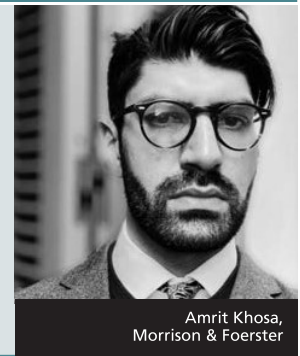


The offshore industry – all at sea

By Amrit Khosa, Of Counsel at Morrison & Foerster in London



It is safe to say that the offshore industry is no stranger to restructurings. The 2014-2016 oil price crash weeded out the companies that relied on higher commodity prices. Those that remained survived by restructuring, relying on lucrative legacy contracts and sound financial management in the good years.

Unfortunately, these industry veterans, who are well used to keeping their nerve amidst oil price cycles, have continued to face oil price volatility, oversupply of rigs and slowing of investment in new projects, whilst being highly levered.

The global pandemic added further pressure, forcing many to restructure yet again.

However, as these oil services companies emerge from restructuring proceedings with purportedly healthier balance sheets, the market conditions remain unchanged.

Operating in a mature and declining industry with continued oversupply of rigs, low demand and dismal day rates, these restructured groups will have to make some painful decisions that could see further restructurings down the line.

Unsustainable debt levels

Much of the oil services industry has struggled with unsustainable levels of debt since 2014. Despite some companies undergoing multiple restructurings, it was not uncommon to see net debt to EBITDA ratios at multiples above 25.0x.

The purpose of many of the 2020/21 restructurings, prompted by the OPEC-Russia oil price war and the pandemic, has been to deleverage and strengthen balance sheets through pre-pack Chapter 11 proceedings in the US.

The term pre-pack here refers to the practice of a company agreeing a restructuring proposal with its creditors prior to implementing the same through the US Chapter 11 process.

In April 2020, Diamond Offshore was the first to file for Chapter 11, but was soon followed by a string of others, including Noble, KCA Deutag, Valaris, Pacific Drilling and Seadrill.

While these drilling companies are emerging or will soon emerge from the process with healthier balance sheets, oil prices are nowhere near recovered and market conditions are still dismal.

Oversupply of rigs

The fundamental problems in the sector persist: oversupply of rigs, reduction in new drilling campaigns, and low oil prices resulting in low day rates.

The reduction of indebtedness has not lessened the impact of any of these factors, and these newly restructured entities will need to make fundamental operational changes to remain competitive and increase utilisation of rigs.

Consolidation and downsizing of rig portfolios to prevent oversupply and match demand is long overdue.

Diamond Offshore retired or sold 30 rigs between 2012 and 2020; others, such as Valaris and Seadrill, have also retired or plan to retire rigs to tackle oversupply.

Drillers with older rigs may struggle to attract lucrative contracts, and trying to sell old equipment may prove challenging. In such circumstances, rigs will have to be sold for scrap metal.

Needless to say, reducing fleets also reduces the assets available for creditors and whatever, if any, income was projected from them.

Those with new build contracts will have to rethink the strategy of bringing yet more rigs into a saturated market, though that is only if they have not already rejected such contracts through their restructurings.

Keppel Corporation's announcement earlier this year to exit the rig building business is a clear sign that there is no market for new rigs in the foreseeable future.

It remains to be seen whether there could be more interest from actual oil companies for acquiring rigs.

Brazilian oil company PetroRio acquired a semi-submersible drilling rig for US\$1 in December 2020 with the intention of reducing operational costs and increasing efficiencies. Were other oil companies to follow suit, this would have the double impact of not lessening supply while decreasing demand for other rigs.

With there being no near-term recovery anticipated in the oil market, companies will also need to consider how to maintain their portfolio of rigs that may impact liquidity since stacking rigs and re-activating them for operations is a costly endeavour.

It was reported that it cost Pacific Drilling approximately US\$15 million to bring its Pacific Khamsin drilling rig back to work.

The longer a rig is stacked, the more expensive it is to bring back to work and the greater the drain on liquidity.

Reallocation of contractual risk

Oil majors, in an attempt to reduce capex costs, are delaying, if not cancelling, new drilling campaigns.

Those that are proceeding are benefiting not only from low day rates

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but also by shifting the risk profile of drilling contracts more and more on to the service providers, who are hungry to accept any contract that prevents stacking cost.

The industry practice of “knock for knock”, where each party covers its own losses howsoever caused, had already been eroded to provide more “skin in the game”, whereby service providers accepted a limited allocation of risk.

Greater pressure to win contracts has resulted in service providers being willing to accept a far greater share of liability.

For example, originally it was customary for the oil company to be responsible for any pollution from the well, regardless of how the pollution was caused and including if caused by the drilling contractor.

With skin in the game, the drilling company agrees to take on anywhere between the first US\$2-5 million of such pollution claims, but now they are being asked to take anywhere between the first US\$50-500 million or, in some cases, unlimited exposure for pollution claims where caused by the gross negligence or wilful misconduct of its personnel.

Not all of this risk is insurable. Major incidents such as Deepwater Horizon continue to be rare, but when they do occur, the numbers involved are substantial.

In such circumstances, creditors may find themselves competing for assets and control with an oil major who is vital for the business, if it is to continue.

Smaller incidents are more regular and, though the numbers may not be large, these can accumulate, rendering a once profitable contract unprofitable for a contractor.

Drilling contractors are also more vulnerable to jurisdictional risk as they are invited to operate in certain African and South American jurisdictions who do not recognise the knock for knock indemnity regimes.

Thus, any pollution risk may end up with the contractor notwithstanding the contract specifying otherwise.

Again, this is not an insurable risk and could result in service providers making large payments whilst pursuing their clients for reimbursement in courts. Termination clauses are increasingly more favourable to oil companies, allowing termination for convenience with limited or no compensation payable to the contractor, or providing termination rights for the slightest of breaches.

The growing risk profile and ease with which contracts may be terminated threatens the liquidity and cash flow of oil service companies.

Increase in costs

A number of oil majors have set ambitious goals for reducing greenhouse emissions, with some European majors aiming for net-zero emission by 2050.

The targets, in turn, require contractors to reduce their footprint. Offshore drilling rigs generate significant greenhouse emissions, with one report suggesting that daily fuel consumption of 40t and 10t is not unusual for a harsh semi or an ultra-deepwater drillship and a premium jack-up, which translates into an estimated 130t and 35t of CO₂ per day, respectively.

New build rigs tend to be more efficient, but as day rates do not support the introduction of new builds into the market, companies will need to invest in improving existing fleets.

Combined with demands for ever-higher health and safety standards, which are easier to meet with new rigs, the need for technical improvements to meet the ever-growing oil company requirements, investment in sustainability and the need to reduce emissions, the cost base for services providers has continued to increase at time when contract day rates are low.

The oil companies’ push for efficiencies and technical improvements has reduced the time drilling contractors need to drill a well, which results in shorter contracts that are already at competitive day rates.

Finding additional liquidity to continue to make improvements is unlikely to come from cash flow, and companies may struggle to raise financing with the growth of environmental, social, and corporate governance (ESG) requirements for certain financial institutions.

The drive for net-zero emission is not without its opportunities.

Carbon capturing and storage, where an empty well is used to store liquefied CO₂, can provide some idle rigs with work.

However, the recent and developing nature of such opportunities means it is unlikely to be a substantial source of income for any one oil drilling company.

The offshore industry is no longer the cash cow it once was, and investors need to be aware of the increased costs and the liquidity requirements caused by industry shifts, which may not support even the restructured debt burdens of drilling contractors.

Cash-pooling

How drilling companies manage cash flow and liquidity is vital.

Use of cash-pooling or zero balance accounts is heavily prevalent in the industry.

Sweeping the bank accounts of several operating group companies, either physically or notionally, to the parent company can have its benefits: reducing the need to borrow externally and the costs associated with same, better internal management of resources and lower procurement costs.

However, it can also create challenges as it impinges on the individuality and independence of each group company.

In financial difficulties, where each company must consider its own creditors, the lack of control over the cash pool can raise concerns of whether sufficient value was obtained by each company in the cash pool or whether such exchanges could constitute antecedent transactions.

Where, following a merger or acquisition, companies seek to consolidate cash pools, creditors will need to be mindful of the impact such arrangements can have on value within their restricted group/collateral package as leakage of value can occur.

Conclusions

The offshore drilling industry has faced many challenges over the last years and service companies have felt the brunt.

The 2020/21 restructurings have aimed to address the unsustainable debt burdens that arose following the 2014-2016 price collapse and have created capacity for consolidation and M&A activity.

However, the underlying issues in the industry are still there and will continue to exert pressure on already unreliable cash flow.

The greater need for investment may, in turn, make what is currently sustainable debt unsustainable relatively quickly.

Those contractors willing to make sacrifices by reducing fleet size, being more competitive on contractual terms and not being afraid to invest in reducing emissions may survive the long winter of low oil prices, but we are likely to see more casualties along the way.