FrontRunner
Under the skin of Subsea, Engineering and Construction Contracting
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New operators grab contractor credibility

The North Sea is a real barometer of the health of the global subsea market. The region moves quickly and reflects oil company confidence in when new offshore spending can make real returns.

The supply-chain being completely reset, and development costs slashed is just part of what helps the North Sea revive itself. But there's something just as important that has to happen to the end client side of the market.

New, smaller operators have to be there to drive a big portion of the projects. Look at the market 10 or 15 years ago, and the cast of expanding independent operators pushing ahead with new, small, relatively fast developments would feature very different names. Small oil companies become bigger oil companies or get acquired or merged. The lean and mean indie of 15 years ago now acts like a major and has very different overheads and priorities.

It's taken a while, but new, reasonably fleet-footed independents are starting to appear. But the smaller ones often need finance to make their projects happen as they will be unlikely to have any real cashflow from existing production assets.

This is where things start to get interesting, or maybe perplexing, for the subsea market. To get that finance, or maybe even float on the UK AIM stock market, those small operators need to present a realistic development plan for what's expected to be their first development. That's what would give investors or financial backers some upside.

Now with the emergence of bundled integrated production equipment supply with subsea construction, those small operators just need one single arrangement to say they've got the development option covered. Then they can get finance and either develop the project or try and get bought by a bigger company looking to increase production by acquisition rather than all new drilling.

There's a fly in the ointment though. The realistic number of integrated equipment and installation groupings that have everything in-house is surprisingly limited. That's when you think of the average North Sea development that might use an FPSO and will need flexible flowlines or at least flexible risers. For subsea tie-backs with rigid lines things are a bit more open.

If it's an integrated option you effectively end up with two options: TechnipFMC (which is the only genuine one-stop shop) and BHGE, though even that is only through a loose installation arrangement with Ocean Installer.

Even within the options those two camps provide; the offering isn't exactly the same. BHGE can offer project finance as well. Lots of contractors and suppliers might be able to offer vendor-financing, but what GE set out to offer was more far-reaching overall long-term project financing.

BHGE did exactly that on the Alpha Cheviot project. That'll will see Ocean Installer handle subsea installation, but there's also a significant diving scope that Boskalis is expected to cover via a project-by-project arrangement with Ocean Installer. A similar deal is already in place for the Cambo development for Siccar Point, which is much more of a phased project, and has some elements (mainly an export line) that the operator will have to bid directly. BHGE is providing long-term Cambo financing as well.

TechnipFMC is doing everything for Hurricane on the phased Lancaster development which allows the operator to stay a very small outfit relying on a contractor to deliver the production. Now TechnipFMC could be doing something similar for an even smaller emerging operator.

That new operator is called Bridge (no relation to the earlier operator of the same name). The project being promoted is dubbed Galapagos, which is actually the redevelopment of the NW Hutton field where Amoco was the original operator. An existing FPSO would be deployed and TechnipFMC would handle the subsea construction workscope plus supply of production equipment and flexible flowlines and risers.

For projects involving flexibles that want to go the integrated route, TechnipFMC and BHGE are now dominating

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Subsea 7 sees 2019 trough

People like to see light at the end of the tunnel. Hope can triumph adversity, though in the subsea market waiting for that to pay off may take a while

Results from the big contractors show things are still really tough. 2018 is probably the bottom of the cycle in activity terms, but that doesn't mean there's a sharp rebound on the way. Quite the contrary. Subsea 7 is even content to suggest that 2019 will be the "trough year both for revenues and profitability".

So even if activity nudges up just a fraction, results will still go down further as most of the work taking place will have been won in the teeth of fierce competition. Initial 2019 guidance from Subsea 7 is for both lower margins and revenues. Beyond that is dampened down as well with Subsea 7 only expecting a "gradual recovery from 2020".

The third quarter Subsea 7 result was still a profit: $76 million on $1.1 billion revenues. Compared to 2017 that's a significant deterioration as then profits were a rosier $111 million on marginally lower revenues.

Within the different business segments, Subsea 7 says the i-Tech ROV division saw revenues drop by $11 million to $66 million. Net operating profit was $4 million compared to the year earlier $6 million reflecting "lower activity levels and underlying pricing pressure". That shows how hard even a big contractor with significant market share finds it to make money from the current ROV segment.

Especially with Siem Offshore Contractors bought and trading as Seaway, Subsea 7 is keen to highlight the corporate position in renewables. But like so many have said before, making money out of wind-farms is still tough, even on mega projects. For the Subsea 7 Renewables and Heavy Lift division, revenues dropped right down from $232 million to $152 million with the Beatrice wind-farm project nearing completion. Operating profit was also well down from $45 million skidding to $17 million. What's worse, next year the Renewables division is only expected to have a "minimal contribution", though 2020 onwards workload is in hand. One of the derrick ships Stanislav Yudin or Oleg Strashnov could be laid-up. First quarter 2019 will see a decision on that. Again, Subsea 7 emphasises that newer contracts now being executed were bid much more competitively with lower margin.

Over at McDermott, the latest results there are also far from pretty. McDermott's purchase of CB&I is causing some real headaches which will take significant time to get over. The latest quarter results are a wipe-out. Profit plummeted to $2 million from a year earlier $95 million tally, even though revenues more than doubled to $2.3 billion.

What smacked the new results in the face were CB&I legacy contract issues. Outside of that McDermott says the "underlying business is strong and has an extremely good outlook". Two of three CB&I legacy contracts – Freeport and Cameron LNG export plants – still have 18 months to run and although "clearly underbid", McDermott is confident those "projects are outliers" and "continue to be de-risked".

McDermott spooks market

The numbers on those problem jobs are huge. In the third quarter $744 million of additional change estimates were identified to complete them. Freeport is in consortium with Chiyoda and Zachry while Cameron is with Chiyoda alone. Cameron has a $6.6 billion contract value but expected $8.1 billion of costs. Freeport isn't quite so bad with a $7.5 million contract value but an expected total bill of $8 billion.

Those issues spooked the stock market, some of which were never sold on McDermott taking over CB&I in the first place. The share price has fallen like a lead balloon. McDermott has taken in more cash with a $300 million private placement with Goldman Sachs, and senior management have also bought more stock to prove their commitment to the company and sorting the issues, though the lower share price must have helped them felt better about doing that too. Chairman Gary Luquette spent $0.5 million on new shares, President/CEO David Dickson $0.4 million, and Executive VP/CFO Stuart Spence $0.25 million ⏮

Muscles flexed

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the process. Others are excluded, even though they could still lead the tenders and get flexible prices from TechnipFMC or BHGE, that just doesn't happen.

Even if those two gave the others competitive prices, they are not on the same terms at all, because both offer much enhanced warranty packages if they get to combine supply and installation. If you're a small oil company, flying by the seat of your pants having to fight for every scrap of raised finance, extended warranties obviously have a real value and offer a measure of security.

And, a smaller operator is not going to go and buy the flexibles direct and free-issue them to an installation. Even if that would mean more competition, it would take a lot more management administration and put some level of interface risk back on the client as well. Even if McDermott and Saipem –and don't forget even Subsea 7 too—wanted to go after such they can't offer the same tight integration, so they can be out of the process even before bidding has really started.

There's an interesting overall twist in this. The new operators with small projects need to prove a level of credibility when they are raising project financing. And they are getting that credibility from the contracting entities they get in bed with. That's something new.

That's something quite different in the project mix. Even though no money has changed hands in the contracting relationship, those new operators are effectively buying project delivery credibility from the integrated contractor.

The contractor involved won't get anything out of it unless the project goes ahead, and even when it does, revenues will be years off. That's taking a lot on faith. Overall where credibility in that part of the market is being sourced form is being turned on its head. And flexible flowlines have suddenly become a critical element to control all over again. ⏮

Pay as you don't go

Pay-as-you-go vessel deals have become a feature of this cycle's down point. However, they remain a function of abject oversupply and only likely really feature at the very bottom of the market trough.

As soon as the market improves by any measure, then you can easily imagine that no vessel owner is going to think PAYG is a good idea. There's no reason to subsidise contractors indefinitely. When things are bleak, finding utilisation at all costs can be justified, but not if there's any meaningful change in the market conditions.

Some vessel owners have had no choice but to switch to PAYG. Expensive boats fixed long-term at the peak of the market can be pretty toxic. For some, if the original charters continued to be enforced, then the cost would take the contractor involved to the wall. Then the vessel owner gets no utilisation and probably ends up with bad debts that never get paid. So that would be ultra-toxic from a different direction.

Reach has been one of the biggest adopters of pay-as-you-go deals. Thought don't forget that company did start out with more traditional charter deals but had to switch to PAYG when the market went south. Reach couldn't pay for the chartered vessels, and the vessel owners helped the company stay alive.

Yet, even at Reach how the contractor controls ships is starting to change. And they highlight the time-limit on PAYG being legitimate, and issues that might in the meantime create.

Reach just did a long-term deal on a brand-new Norwegian-built ship. That's a 30-month firm plus three one-year options time-charter on the newbuild ROV support vessel Topaz Tiamat. First quarter 2019 will see the charter start and Reach will use the vessel under the existing co-operation deal with Swedish company MMT. However, note that deal is a traditional charter with Topaz to be paid every day. Some sort of profit share is also included, though how that works hasn't been revealed.

Topaz also has a sister ship newbuild called Topaz Tangaroa. A charter deal there is also thought under negotiation. That could soon be confirmed as well. Who's taking the Tangaroa remains to be formally confirmed.

Back at Reach, if you're controlling a ship that has to be paid for every day, that's always going to be what you put forward for work first. That's just common sense. While that doesn't sound instantly sinister, it has important implications for the PAYG ships Reach is still involved with. A vessel owner remaining happy with a PAYG deal when the company involved has long-term, traditionally chartered vessels to find work for first, is hard to believe. That creates a different sort of stress in the market. Then the owner with a PAYG ship is still carrying the can, but well down the pecking order when it comes to being offered for or mobilised for work.

Some sources are reporting the banks and financial backers of some of the vessel owners are also souring on the merits or otherwise of PAYG deals. They don't see them adding value and think they can sometimes limit work opportunities as well. With owners under distress, the banks can take a very detailed interest in the shipowners' operations.

When debt has been swapped for equity or security on amounts owed have been slashed by write-downs, often it's really the banks' money that owners are playing with in any case. The banks can effectively be controlling the vessel owner. That's already known to have prevented some speculative vessel relocations when banks have thought it not worth spending the money on fuel for. Some might think that's meddling, but from the banks' point of view it's just simply governance of a lender that's in default.

Most of this pay-as-you-go phenomenon is on the ROV support side of the market. That's very logical when the segment is the most commoditised of all the subsea market areas. When you see similar deals emerging for much bigger vessels, there's quite specific reasons for that. Normally it's because a vessel has finished an existing charter and there's little point in incurring the cost of removing contractor equipment on board. There's a very, very limited spot market for bigger construction support vessels, vessel owners can't hope for short-term work suddenly appearing, and for more medium term requirements, contractors can still play the field to their advantage.

Owners have no power to negotiate

Yet one large vessel has seen a long-term term charter turn into what is effectively a PAYG deal. Solstad has confirmed that the Ocean Installer deal for control of the Normand Vision construction support spread has changed. Originally that ship was on an eight-year plus options charter all the way through to October 2021. Now it's not a firm charter at all, but rather a "marketing framework" with the same 2021 end date.

That switch appears to come down to Ocean Installer not being able to stomach the peak cycle rate on the vessel in a very different market. And, Ocean Installer appeared to have some corporate means and structure that there was the potential to walk away for the charter while only cratering a subsidiary company rather than the whole group.

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Owners over a barrel

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Solstad therefore had little choice, as otherwise it would be stuck with a vessel with no easy new home to find. Effectively that becomes a pay-as-you-go deal, though at least some days per year are thought still guaranteed. Ocean Installer might also be close to a deal for a long-term access arrangement on a further construction support spread. Shortly, full details of that are expected confirmed.

If you're Solstad, there's little you can do. Better to keep on being paid some of the time, hopefully most of the time, than not at all. There' nothing the ship-owner can do to fight back, apart from dream of a time when trading conditions will be different, and it can remember how to put the boot back on the other foot.

Vessel owners are massively exposed. Even for the third quarter that should be boosted by seasonality in the North Sea, the results being posted are deep red. Back at Solstad, the third quarter bottom line was NKr 456.1 million of losses on NKr 1.4 billion of revenues. That's even worse than last year when the loss was NKr 375 million and revenues were a smidge higher. Solstad sees "signs of improvement in most markets, but the recovery is slow and the rate levels still not at sustainable levels". Solstad is still in another round of refinancing talks, and the owner thinks under the current conditions "the book values of the vessels and equity will be under pressure".

Even a notably conservative Norwegian owner like Rieber has just posted a loss. That red number was NKr 49.1 million on NKr 69.6 million revenues. That's sharply down on last year when Rieber was still NKr 28.3 million in profit and revenues were a healthier NKr 80.9 million. Rieber sees a "continued uptick" in subsea and renewables activity but douses that down with iced water by adding there's been no change in rates leaving "continued challenging market conditions and unsustainable rates".

Bourbon is a bit more circumspect with releases on financial performances but does say for the third quarter revenues were slashed from €204.3 million to €169.2 million. The French owner suggests average rates "held up, despite overcapacity and gradual renewal of long-term contracts at persistently low 'market' rates". ⏮

Get off your bottom

All markets turn. The subsea market might be bouncing along the bottom right now, but change is coming. The inflection point when demand can improve again can be seen. Though like that unreliable acquaintance that's the soul of the party, just don't expect it to turn up right now or on time. It's on the way though.

That's an improvement in demand. Sounds good. But that doesn't even mean in the next five years demand will be back to where things were at the most recent peak. And even if it did, the supply side is completely different. Supply has grown so much that, while welcome, modest increases in demand, won't tighten the market that much. Rampant supply will keep the market out of balance. That makes for an industry that's going to be a lot more complicated and a lot trickier.

Immediately things are still tough, but there is light at the end of the tunnel. Understanding how that's going to play out is paramount.

There's already wreckage strewn over the pitch, and more will follow. Realignment, refinancing, consolidation, and all sorts of moves will come with it. Some of it to deal with the huge sums already spent, that now looks like a busted flush. Some of it as smart money moves it to try and take advantage of others' distress and do deals at the bottom of the market.

Strategic Offshore Research's definitive annual **Global Subsea Market to 2022** report tells you what you really need to know about the market. The report is forthright and direct. All the needless noise and wailing of the industry is stripped away for straight to the point answers. What you really need to know. The report gives you the brass-tacks of where the market is and is going. With the market tougher than ever before, being aware of what the issues and risks are has never been more vital.

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