EPEUS

In 2015 McKinsey & Company wrote a paper on, *The Outlook for Offshore Drilling.*

In this paper, we review McKinsey's forecasts and find out if their predictions align with the current market trends, by examining the current performance of the floater and jack-up markets.

2018 & Beyond: A Retrospective Look at MODU Supply and Demand

Introduction

In 2015 Marcel Brinkman, Partner of McKinsey & Company, wrote a paper entitled, *The Outlook for Offshore Drilling.*

The paper discussed three main topics:

- **The role for offshore oil in the global supply mix**: the future role of offshore will be determined by a number of factors such as, net demand growth, mature field decline, LTO (Light Tight Oil) growth, and offshore growth (i.e. new offshore production)
- **The outlook for the floater market** (i.e; Semi-submersibles and drillships)
- **The outlook for the jackup market**

Many will recall that at the time of McKinsey publishing its paper, the generally held view across the industry was the downturn would be relatively short lived. The “lower for longer” sentiments only appeared in 2016 following the rapid and steep decline in the price of oil in January of that year. McKinsey’s paper was therefore somewhat controversial in that it forecasted rig utilization only returning to pre-2014 levels for Floaters in 2019 and not until 2021 for Jack-ups, hence predicting a much longer downturn than most were anticipating at the time.

Therefore, three years on from it being published, we thought we would explore current rig utilization trends to see if they support McKinsey’s forecast. Whether or not recent trends underpin rig utilization returning to pre-2014 levels are imminent for the floater market and still further in the future for the jack-up market.

One of the most interesting considerations, if McKinsey has nailed its forecasts is; what does this mean for the drillers and their supply chains ability to react to any change in market conditions in 2018/19 after a prolonged period of downsizing, stacking and stagnation?

1. The floater market

McKinsey forecasted that demand for floaters is expected to be back to pre-2014 levels in 2019 and to peak in 2023, driven by Africa, Asia and Brazil. The market should tighten starting in 2017, after ~50 floaters have been cold-stacked:

- Utilization will suffer until 2016 end-of-year as demand falls and the market is oversupplied
- Utilization should start recovering in 2017 when we see renewed demand growth and oversupply has been addressed through high cold-stacking rates and postponed deliveries from the orderbook
- The market should be fully balanced in 2019-20 when utilization comes back to pre-2015 levels around 90%, triggering new orders that should be delivered starting in 2020.

Current Observations & Trends:

We won't know if the market returns to pre-2014 levels in 2019 until we get there however, the latest data (*Figure 1*) shows that current market trends tend to support McKinsey's predictions for semisubs whereby the utilization rate of these types of rig has started recovering in 2017. However, there has not yet been signs of a similar rebound in drillship utilization.

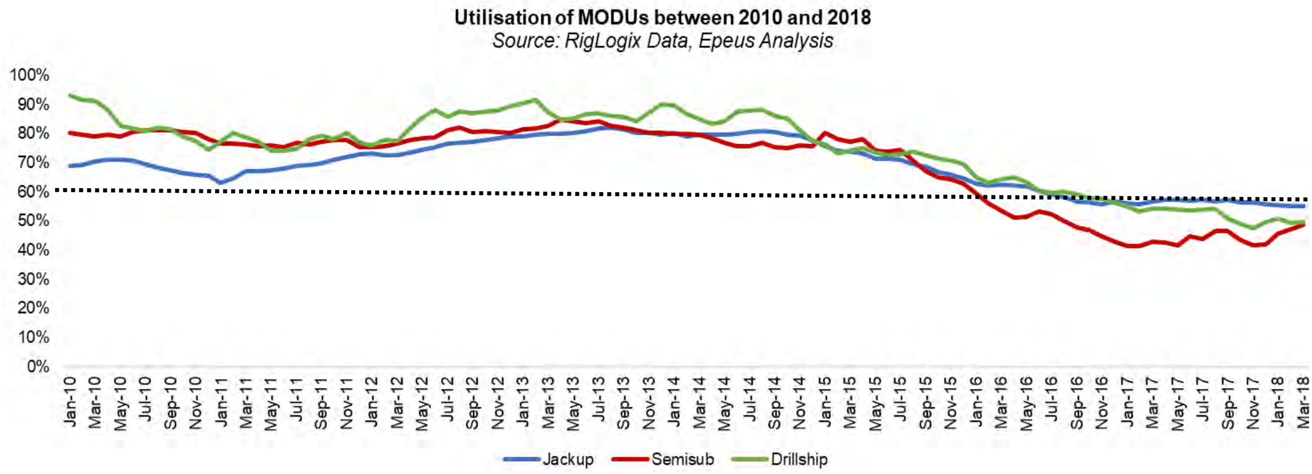

Figure 1 - Utilization Rates of MODUs (Mobile Offshore Drilling Units)

So far, in relation to cold stacking numbers, our 2017 market insights paper reported that, 25 semisubs and 22 drilliships were cold-stacked, a total of 47. McKinsey's forecasts of the market tightening were based on around 50 floaters being cold-stacked.

McKinsey also attributed future floater demand growth to be dependent on increased activity in Africa, Asia and Brazil. Looking at Baker Hugher's monthly rig count (*table 1)* below, the rig count went down between April 2017 and April 2018 for Africa, Latin America, Middle East, Asia Pacific and the United States.

Table 1 – Extract from Baker Hughes, a GE Company, Offshore Rig Counts

	April 2017 Offshore Rig counts	April 2018 Offshore Rig counts
Latin America	32	26
Europe	31	34
Africa	13	15
Middle East	45	43
Asia Pacific	80	76
International	**201**	**194**
United States	20	16
Canada	0	3
North America	**20**	**19**
Worldwide	**221**	**213**

Source: Offshore Energy Today data, Epeus Analysis

However, North Sea demand for floaters is picking up. An undersupply in the Norwegian harsh-environment semisub market is forecasted for the next few years. Additionally, the UK mid-water moored semisub market is also starting to tighten with demand to continue increasing through 2018 and 2019. Some drillers, such as Diamond Offshore and Transocean are now reactivating (or seriously considering reactivating) cold-stacked floaters due to a lack of available ready-stacked units.

According to RigLogix, as of May 2018, 15 of the 19 marketed harsh environment semisubs based in Norway were contracted, including four awaiting the start of their contracts. Three of the 15 will potentially complete contracts in 2018, while the reminder are committed for 2019 and beyond. The most recent contract signings saw day rates for units in the North Sea reach over $300,000, substantially higher than rates secured earlier in 2017 (MODU average).

For new floating rigs the current orderbook stands at 37 competitive units, 25 of these currently having 2018 delivery dates. Nevertheless, lack of contract awards will result in those dates continuing to move into 2019 or even later.

Semisub utilization trend has shown an upward trend from early 2017. This begs the question, is the increase in utilization due to increased demand or rig attrition? Current utilization trend data is inconclusive in order to assume the growth predicted by McKinsey. Utilization rates would also be impacted by rig attrition. A recent RigLogix (2018) article discussed rig attrition and cold-stacked rigs concluding, in most cases these rigs are not included in the utilization calculations and have no impact on the day rates contractors bid or receive.

2. The jack-up market

At time of publication, McKinsey expected 6 years for the jack-up utilization to return to 2014 levels after more than 100 jack-ups have been removed from the active fleet:

- Jack-up active fleet utilization is expected to be at its lowest in 2016-17, reaching ~65% due to oversupply and a pause in demand growth
- McKinsey expected a slow demand growth recovery for this market, meaning that the market balance recovery will be driven by addressing oversupply through retirements of the 30+ year old assets by 2020
- Market balance should be back around 2021 when it reaches healthier utilization levels of 85% for the active fleet.

Current Observations & Trends:

Referring to *Figure 1* above, the reality appears worse than McKinsey's forecast on jack-up active fleet utilization. Since mid-2016 the utilization rate of jack-ups has been less than 60% and the downward trend continues.

T*able 2* shows that there has been a 43% decrease across all MODUs (Mobile Offshore Drilling Units). There have been more floaters and jack-ups cold-stacked or scrapped than the McKinsey's forecast requirements for the market to tighten. Until recently jack-up owners have been reluctant to send their rigs to the scrapyard. Now, as low dayrates persist and old rigs continue to rot, the likelihood that older rigs will ever come back into the market again has all but disappeared. Owners' realisation of this, combined with higher steel prices and more scrap buyers, is driving the increased trend in jack-up scrapping we're seeing today.

Commenting on this, Borr Drilling (2018) stated that the cost and investments required to bring old, unemployed rigs back to the drilling market cannot be defended from a financial, operational or safety point of view.

RigLogix analysts believe that there are at least 25 rigs that are good candidates for permanent retirement from the fleet in the first-half of 2018. Bassoe Analysts on the other hand, expect to see up to 60 rigs scrapped or sold for conversion in 2018, around three times the amount retired in 2017.

For example, in 2018 Borr and Paragon have sold off 26 rigs which will all leave the actively marketed jack-up fleet; 14 of which were sold to a non-drilling company.

Table 2 – Rigs Active by Year

	2014	2018	Change
Jack-up	373	254	- 109 (29%)
Semisub	148	38	- 110 (74%)
Drillship	73	34	- 39 (53%)
All MODU	594	326	- 258 (43%)

Source: RigLogix data, Epeus analysis

McKinsey's report appears right on saying that there would be a slow demand recovery for the jack-up market. In 2017 there were few sales and even fewer deliveries of new jack-ups. In October 2017 Borr Drilling purchased nine newbuild jack-ups from Jurong Shipyard in Singapore. Expected delivery date for all nine newbuilds is scheduled for 2018 and 2019.

Recent reports suggest that Borr Drilling is to incur a final financial loss in 2019, before generating positive profits in 2020. This news aligns with McKinsey's predictions of the jack-up market stabalising in 2021.

Conclusion

Let's not forget that McKinsey made their predictions three years ago when they forecasted the floater market would return to pre-2014 levels in 2019. Less than one year away, we can see signs of the floater market picking up; especially for semisubs. For the jack-up market, as they rightly said it would be a slow recovery and this is clearly evident from what we are observing in the current market. However, things could quickly change.

It appears that the industry is on the road to recovery. Since, April 2018 the oil price (Brent crude) has been trading above $70 per barrel ($78 at time of publishing). According to Bank of America, oil prices could hit $100 per barrel next year.

Uncertainty about the market has made it difficult for drillers and field operators to start planning their pick up activities. Rather, they appear to remain focused on cost saving, resource optimization, lean business structures and new business models based on partnership.

Massive downsizing has the ability to inflict substantial damage on the learning and memory capacity of organizations. Many drillers and field operators have lost key and experienced resources, which may have resulted in short-term reduction in labour costs. This may have also undermined long-term competitive advantage, due to eroding of competence, embedded processes, historical data, and operational capabilities.

Over coming these will be one of the main challenges faced while meeting increased demand for rigs. Readiness is all.

References

Brinkman, M. (2015). *The Outlook for Offshore Drilling.* McKinsey & Company.

Childs, T. (2018, January 4). *Rig Trends: Offshore Rig Fleet Poised for Comeback, but More Time is Needed*. Retrieved April 4, 2018, from Rigzone: https://www.rigzone.com/news/rig_trends_offshore_rig_fleet_poised_for_comeback_but_more_time_is_needed-04-jan-2018-153025-article/?pgNum=0

Exarheas, A. (2018, April 4). *'Significant' Discoveries Made Offshore Norway.* Retrieved April 4, 2018, from Rigzone: https://www.rigzone.com/news/significant_discoveries_made_offshore_norway-04-apr-2018-154112-article/

Kottasová, I. (2018, May 10). *Oil prices could hit $100 a barrel next year, Bank of America says.* Retrieved from CNN: http://money.cnn.com/2018/05/10/investing/100-oil-iran-trump-bank-of-america/index.html

Murphy, K. (2018, March 22). *Borr Drilling Limited (OB:BDRILL): Is Breakeven Near?* Retrieved April 4, 2018, from Simply Wall ST: https://simplywall.st/stocks/no/energy/ob-bdrill/borr-drilling-shares/news/borr-drilling-limited-obbdrill-is-breakeven-near/

Offshore. (2018, May 3). *Patchy pickup in offshore rig demand, report finds.* Retrieved from Offshore Magazine: https://www.offshore-mag.com/articles/2018/05/patchy-pickup-in-offshore-rig-demand-report-finds.html

Offshore Energy Today. (2018, May 7). *Baker Hughes sees uptick in monthly international offshore rig count.* Retrieved from Offshore Energy Today: https://www.offshoreenergytoday.com/baker-hughes-sees-uptick-in-international-offshore-rig-count/

Offshore Energy Today. (2018, April 30). *Borr Drilling sheds 14 jack-up rigs.* Retrieved from Offshore Energy Today: https://www.offshoreenergytoday.com/borr-drilling-sheds-14-jack-up-rigs/

Shinn, D. C. (2018, April 16). *Borr and Paragon kick off "Jackup Scrapfest 2018", and the party's just getting started.* Retrieved from Bassoe Offshore: https://www.bassoe.no/borr-and-paragon-kick-off-jackup-scrapfest-2018-and-the-party-s-just-getting-started/news/95/

The Epeus Group

We are an independent Project Risk Management Firm providing Advisory, Assurance, Technical Support and Project Rescue services to our clients in the Oil and Gas Industry with focus on Upstream. We help our clients to feel more certain about their investments and projects and to manage their financial and reputational risks. Our clients include those organizations that invest, own, operate, and manage large and complex projects.

For more details visit our website at www.epeusconsulting.com

Contacts

Mark Thompson
+44 7734 874749
mthompson@epeusconsulting.com

Andrea Petrone
+44 7904 190425
apetrone@epeusconsulting.com

Claudette Gaius
+44 7519 116339
cgaius@epeusconsulting.com