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ALLIANCES IN OILFIELD SERVICES

A WIN-WIN FOR OPERATORS AND CONTRACTORS?

By Odd Arne Sjåtil, Philip Whittaker, and Luigi Chiolini

PROTRACTED WEAKNESS AND VOLATILITY in commodity prices have taken a punishing toll on oil and gas companies. In response, these companies have focused heavily on increasing efficiency and reducing costs. The current wave of alliance activity—including alliances, joint ventures (JVs), and M&A—among oilfield services and equipment (OFSE) companies, which is spawning an array of promising new offerings, could prove to be a critical enabler of these efforts. And it could make a meaningful difference to the business prospects of OFSE companies, which are also under considerable pressure to cut costs and boost revenues.

Successful outcomes for both operators and contractors are by no means guaranteed, however. In addition to their potential benefits, these alliances present risks to oil and gas companies. These include the risk posed by the growing market share captured by these alliances, which gives participating OFSE companies considerable pricing power. OFSE players in these alliances also face risks, including the challenges of integration and of delivering a credible and distinctive value proposition.

A New Wave of Alliances, JVs, and Mergers

The current downturn in the oil and gas industry is worse than most companies and analysts had envisaged. This challenging industry environment has had a substantial impact on oil and gas companies, many of which have made substantial cutbacks in capital spending and head count.

Amid the industry's challenges, however, there are reasons for encouragement. These include the improvements in efficiency that the industry has already achieved and continues to pursue. Driven by the quest for greater efficiency and lower costs, the industry is experiencing sweeping changes across its entire landscape: increasingly innovative solutions, growing standardization, and surging creativity in the development of new cost-saving technologies.

In parallel, there has been a new emergence and acceleration of alliance activity, including JVs and M&A, among OFSE companies as they rethink their business models and try to improve the attractiveness of their offerings in response to this environment. (See Exhibit 1.) The first such combinations encountered skepticism among other OFSE players. But increasing numbers of OFSE companies have formed alliances of their own as these combinations appear to be demonstrating real value and gaining acceptance among oil and gas firms.

Most of these combinations fall into three categories (see Exhibit 2):

- **Oilfield services providers expanding their offerings.** Examples include Schlumberger's acquisition of Cameron; Baker Hughes's alliance with CGGVeritas; and, most recently, GE Oil & Gas's acquisition of Baker Hughes. Even the failed merger between Halliburton and Baker Hughes, although motivated mainly by its potential operating and financial synergies, could be viewed as an example of this type of combination.

- **Subsea production system (SPS) manufacturers teaming up with subsea umbilicals, risers, and flowlines (SURF) installers.** Examples include the merger between FMC Technologies and Technip and the collaborations between OneSubsea and Subsea 7; GE Oil & Gas and SapuraKencana; Saipem and Aker Solutions; and GE Oil & Gas and McDermott.

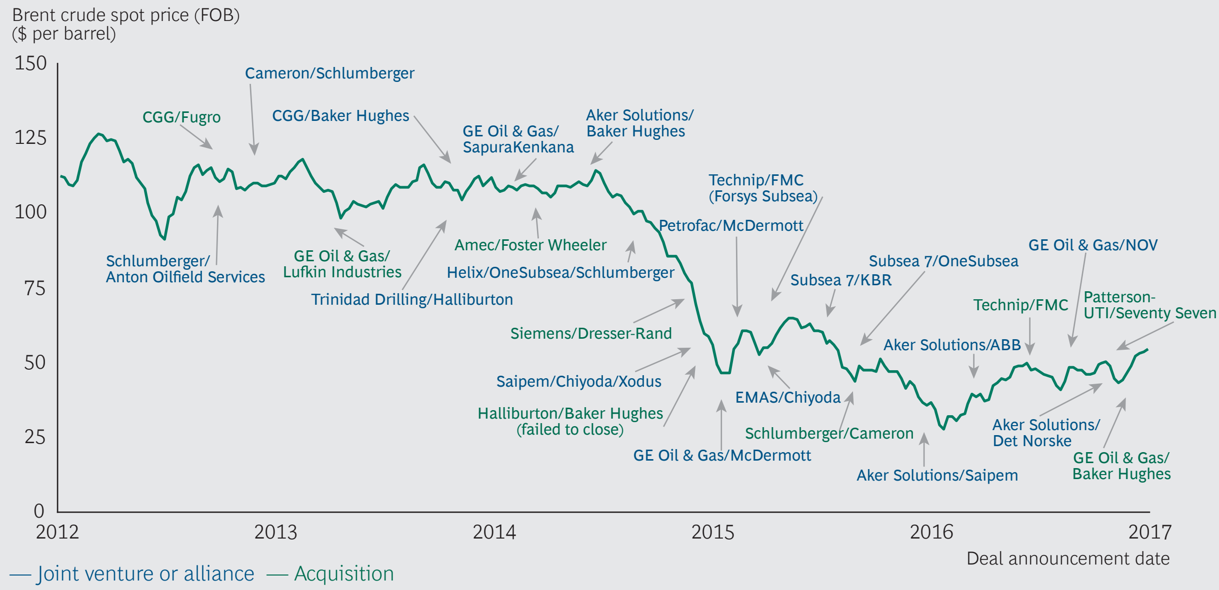
- **Process engineering firms joining forces with installation contractors.** Examples include Subsea 7's alliance with KBR, Petrofac, and McDermott; and the JV between EMAS and Chiyoda.

We believe that five forces support further alliance, JV, and merger activity in this environment:

- The desire among oil and gas companies for engineering solutions that structurally lower costs, reduce lead time, and improve the reliability of delivery.

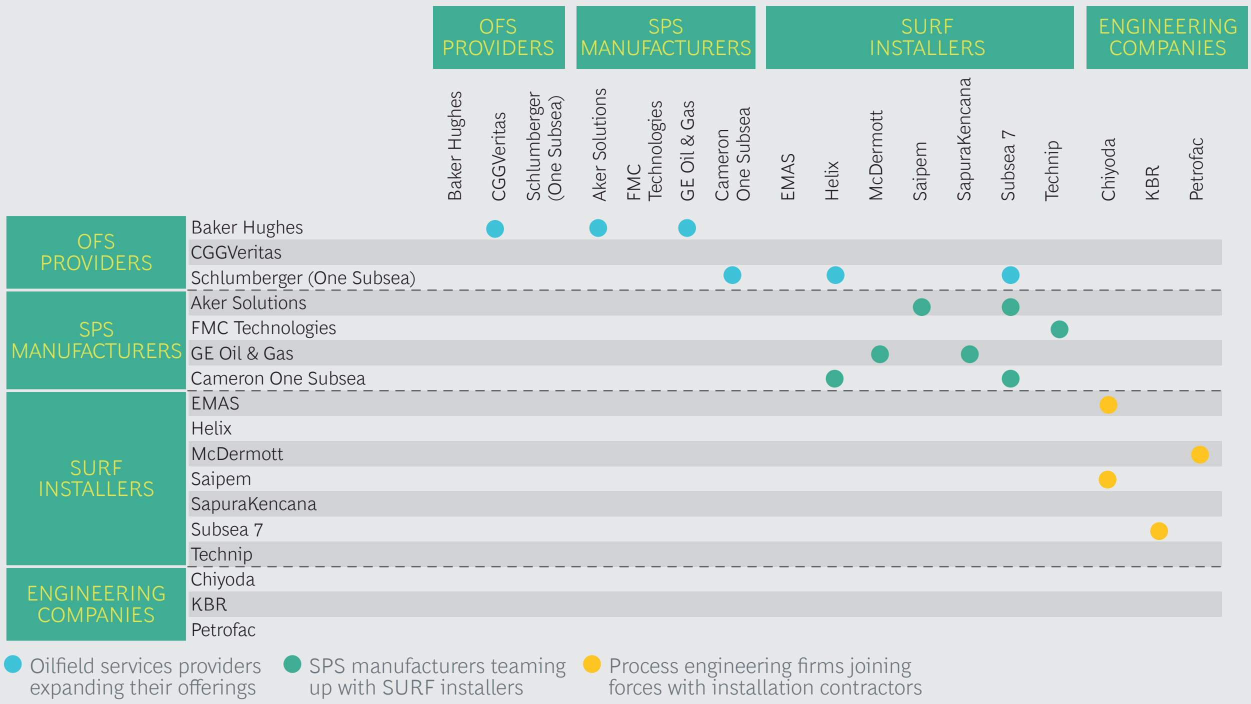
- The perceived need among oil and gas companies for business model evolution and a step change in operational efficiency. Oil and gas companies also want to be able to reduce interface costs between or among multiple contractors and hold one contractor responsible.

EXHIBIT 1 | Alliance, Joint Venture, and Merger Activity, 2012–2017



Sources: IHS Connect; Mergermarket; U.S. Energy Information Administration; BCG analysis.
Note: Activity highlighted in the exhibit is non-exhaustive. FOB = free on board; NOV = National Oilwell Varco.

Exhibit 2 | Three Main Types of Alliance Have Emerged



Source: BCG analysis.
Note: The alliances highlighted are illustrative. OFS = oilfield services; SPS = subsea production systems; SURF = subsea umbilicals, risers, and flowlines.

- The opportunity for OFSE players to secure inexpensive access to valuable assets and capabilities. Some OFSE companies are in financial distress; this presents opportunities for others to gain access to assets (of contractors) and proprietary know-how (of product and service companies) at attractive rates.

- The desire among OFSE companies to secure revenues by engaging oil companies in the very early phases (that is, the concept and front-end engineering and design [FEED] stages) of projects. Securing early engagement could allow OFSE companies to lock in later-stage asset and product revenues.

- Concerns among OFSE players about being left behind competitively by other companies that team up and define new delivery and contracting models.

Additionally, oil and gas companies, concerned about the potential effects of OFSE alliance activity on competition and pricing power within the industry, may encourage additional alliances in an effort to broaden the number of contractors offering certain solutions.

Opportunities and Risks for Oil and Gas Companies

OFSE alliances offer oil and gas companies the potential for sizable cost cuts and gains in efficiency. This holds especially for the development of offshore resources. Making these projects more cost-efficient demands considerable engineering firepower, and some of the biggest players interested in this arena—including Saipem, Technip, Aker Solutions, and Subsea 7—are aggressively pursuing this, having already formed alliances to further boost their scale and expand competencies. Such efforts could ultimately transform the competitive dynamics of the offshore and subsea markets.

Through the delivery of innovative packaged solutions, OFSE alliances could also help oil and gas companies substantially reduce their interface costs, risks, and coordination requirements. In addition, OFSE providers could offer solutions that help oil and gas companies reduce their startup time to "first oil" and improve oil recovery efforts in brownfield basins.

Moreover, these alliances could develop new technologies that otherwise might not have been conceived. These technologies could prove valuable in enhancing reservoir recovery rates or lowering project costs.

In addition to their potential benefits, however, OFSE alliances pose risks to oil and gas companies:

- **The potential for higher prices.** The concentration of key capabilities in fewer OFSE companies could lead to greater pricing power for these players, especially when the oil cycle improves. For example, the four largest alliances that integrate SPS and SURF capabilities—Technip/FMC Technologies, Subsea 7/Cameron, Saipem/Aker Solutions, and GE Oil & Gas/McDermott—accounted for a large majority of the total market spending in these segments over the past decade. Accelerated consolidation could give these companies even greater pricing power. It could also force other OFSE players to "go big" if they want to compete, leading to further consolidation.

- **The possibility that contractors will compete to lock in proprietary standards.** This would force oil and gas companies to manage the risk of being advised on technical solutions by suppliers with conflicts of interest. These companies will have to determine how much technical depth they should keep in-house and what level of control they should seek over the supply chain.

- **Fewer options to mix and match suppliers across categories.** The reduction in the number of suppliers will be exacerbated by continued attrition among these companies due to the sector's ongoing financial distress.

- **Challenges meeting government procurement rules.** Suppliers' bundled offers could make it difficult for oil and gas companies to adhere to government procurement guidelines, particularly with regard to local-content requirements. International oil companies may need to support national oil companies and local governments in the design of efficient contract terms and requirements.

To maximize their chances of realizing the value these new entities could offer while mitigating the risks, oil and gas companies will likely have to reconsider their current procurement approach, engaging early in the design process and with a view toward a longer-term partnership.

Keys to Success for OFSE Companies

To position an OFSE alliance optimally and maximize its chances of success, participants must make critical decisions about the alliance's design. They must ask themselves the following questions:

- What type of agreement between or among parties should we adopt—a memorandum of understanding, a JV contract, or something else?

- How strongly—measured by the number of people dedicated specifically to the alliance, for example—should we commit to the alliance?

- What is the ideal size and scope of the alliance? Is the alliance focused on the core business or adjacencies?

- What is the nature of the offering? Is it a joint integrated offering that has an associated delivery model or simply a combined commercial offer?

- How should we assign responsibility for tendering and technical development costs? Should costs be shared?

- What is our strategy for profit sharing? Is the strategy aligned with the commercial interests of the alliance?

- What are appropriate incentive mechanisms? Do we have them in place?

Answers to these questions will vary considerably, given the wide range of development trajectories that these deals can take. In some cases, an alliance is a first step toward a merger or acquisition ("engagement before marriage"), as was the alliance between FMC Technologies and Technip that spawned Forsys Subsea. An alliance can also be a trial move, one that is inspired by commercial needs but ultimately lacks a real technical and operational value proposition.

It is worth noting that alliances and JVs have materialized in previous cycles, though most have not had a lasting and material impact on the oil and gas industry. History also tells us that, in many cases, soft alliances (JVs and partnerships, not M&A, obviously) tend to fall apart when oil prices rebound and companies feel strong enough to pursue strategies unilaterally.

Assuming a JV or an alliance is intended as a long-term venture, we believe that there are four key preconditions for its success:

- **The ability to articulate and deliver a strong customer value proposition.** This proposition must be compelling to the customer on multiple fronts, such as quality, speed of delivery, and in-service support. OFSE players should be able to document actual cost savings that are driven by, for example, reductions in vessel days, lead time, crew and project team size, and material and equipment costs. OFSE companies should also create customized communications that convey their value proposition to the various stakeholders of the operator organization, including asset owners and personnel from operations and technical functions.

- **New and appropriate contracting models.** These models need to reflect the entity's updated value proposition and business model. Mechanisms must be in place that balance very different value propositions over the course of the project life cycle. (Is the venture focused on winning the $10 million FEED contract or the $100 million installation work?) Examples include lump-sum, risk-sharing, and accelerated-schedule models.

- **Early engagement of, and collaboration with, clients.** Alliances need to give clients input on concept design as well as the design of delivery and service models. Oil and gas companies will be entrusting these alliances with tasks that they would have performed on their own in the past; the challenges for the alliance will include determining how to strike a balance between the independent thinking necessary for effective FEED and the desire to lock in business.

- **Real commitment and genuine alignment between or among the parties involved in the alliance.** Securing these will force participants to reach agreement on several questions: How can we best align businesses and cultures that have different emphases (for example, sales versus utilization, or speed versus quality) over different timeframes (for example, FEED this year and installation in two years)? How can we persuade top talent to commit to the team? How can we align incentives for sales and marketing teams? How can we achieve the genuine alignment necessary to overcome complex operational and cultural challenges related to the integration and comanagement of assets, products, services, and projects—and demonstrate that alignment to operators?

OIL PRICES NOW stand substantially above their lows of early 2016 but are still roughly half what they were before they began their extended slide in mid-2014. As a result, oil and gas companies as well as OFSE players continue to face considerable ongoing financial pressure. OFSE alliance activity could prove an important part of the answer for both types of company.

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