The Russian Oilfield Services Market in 2016–2017

KPMG in Russia and the CIS

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Introduction

The market of oil and gas companies is global and largely determined by the global business environment, while the Russian market of oilfield services is quite local and fragmented. That is why it is especially interesting to look at its state and dynamics in 2016-2017, all the more so as the last year was quite eventful for the oil and, consequently, the oilfield services market — it saw oil price stabilization, extension of sanctions, and an agreement with OPEC on oil production freeze.

As part of this market research, we have analyzed numerical indicators and characteristics of the Russian oilfield services market, and interviewed executives and representatives of large and medium-sized oilfield service companies. The results of the research are controversial. On the one hand, the oilfield services market is well-positioned for a booming growth in the coming years, but at the same time the market attractiveness for independent oilfield service companies is under threat.
The agreement with OPEC on oil output cuts and its impact on oil production in Russia

For several months, the attention of politicians, economists and the majority of citizens was grabbed by the agreement with OPEC on oil output cuts (the Agreement) and its subsequent extension. Oil market experts had more questions than answers. In particular, a separate task – and quite interesting one – is to determine target production levels by country. Official releases announced only obligations to cut production, while in fact it is the base level for calculation that determines target output figures. And the most interesting thing is that the daily oil production in October 2016 was record-breaking for Russian oil companies.
Figure 1 below shows the average daily output by months, the average annual level of the daily output and our estimate of the target “limit” under the agreement with OPEC.

Figure 1. The average daily oil production in Russia, thousand barrels

The target output under the Agreement exceeds the average figure for 2016, so Russia does not need to cut oil production in 2017 and even has room for a small increase.

Speaking of reasons and preconditions for this situation, it is important to remember that in September and October 2016 oil production in Russia increased considerably. In October, oil production grew by 4% as compared to the similar period of the previous year, which is 2 times higher than the growth rate of the average annual level. This fact ensured the effect of a high base when calculating the target output for Russia and helped reduce the risks related to oil production cuts.

In terms of the oilfield services market, this suggests that the Agreement is not expected to have any negative impact on the amount of drilling, repair and other oilfield services.

This point of view is supported by our interviews: none of interviewed executives or representatives of oilfield service companies mentioned the Agreement among negative factors for their business or future risks.

Interestingly, the situation with sanctions is similar. They have influenced only providers of seismic survey services and, in practice, this influence has been rather insignificant. First of all, this is due to the fact that sanctions influence production from complicated offshore and Bazhenov Formation reserves. As full-fledged development of these reserves has not started yet, this means that sanctions lead to a shortfall in production growth rather than to current output losses.
The overview of drilling volumes and structure in 2016. Trends

The volume of drilling is the key driver of the oilfield services market.

This is explained not only by the fact that drilling is an expensive service in itself, but also by the fact that drilling serves as an indicator of the volume of the market for related services, including cementing, telemetry, completion, etc. That is why this market segment deserves close scrutiny.

First of all, let us look at oil companies’ drilling volume dynamics in recent years and our forecast (Figure 2).

In 2016 (for the second year in a row), drilling volumes experienced double-digit growth.

As compared to 2014, the market volume increased by more than 25%.

The key growth driver is the increase in the number of meters drilled by Rosneft.

Figure 2. Production drilling dynamics, million m
Our forecast is primarily based on Rosneft’s statements that they will keep drilling volumes at “over 10 million m per year”\(^1\), as well as fewer large new production projects. At the same time, the good news is that LUKOIL plans to increase drilling in Western Siberia\(^2\).

Executives of oilfield service companies note that the market growth in monetary terms will be lower than the volume growth due to a decrease in the unit cost of services.

Increased drilling volumes are accompanied by a growing share of horizontal drilling (Figure 3). This trend corresponds to the global one and is positive, since horizontal drilling is more cost-effective and technologically sound. The shift to horizontal drilling is mutually beneficial to oilfield service companies and oil producers: it is a higher margin business for the former and increases the return on investment for the latter.

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**However, we forecast a reduction in growth rates in 2017 and then in 2018.**

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\(^1\) [https://www.rosneft.ru/upload/site1/document_cons_report/FY2016_Results_27022017_RUS.pdf](https://www.rosneft.ru/upload/site1/document_cons_report/FY2016_Results_27022017_RUS.pdf)

Figure 4 shows the structure of growth in drilling volumes by company. We see that Rosneft is the key driver of larger drilling volumes. Taking into account that Rosneft has its own drilling company and a strategy to use its own oilfield services, we can say that the size of the open market has not changed significantly.

Figure 4. The structure of growth in production drilling volumes in 2016 as compared to 2015, million m³

Figure 5 shows the different direction of changes in drilling volumes by oil companies. While Rosneft has considerably increased its drilling volumes, Gazprom Neft and LUKOIL, on the contrary, are reducing them. For analysis, let us compare drilling and production increases by companies and consider the structure of the oil output growth.

Figure 5. Production drilling and oil output growth dynamics in 2016 by oil and gas companies, %

Sources: Central Control Administration of the Fuel and Energy Complex, company data, KPMG analysis
Although the overall growth in production in 2016 was quite a significant 2.5%, this growth was driven not by large oil companies, but by other producers and NOVATEK.

For example, the growth in production volumes as compared to 2015 reached only 0.5% for Rosneft and 0.4% for Surgutneftegaz, while other producers increased their output by 5%. Comparing the low growth rates of Rosneft’s production with a significant increase in its drilling volumes (35%), one may conclude that production at the company’s old wells has fallen significantly. As the overall production decrease for Rosneft is unlikely, we forecast an increase in this company’s demand both for services to enhance oil recovery and services to perform hydraulic fracturing and drilling in new regions.

Gazprom Neft deserves a special mention. A significant growth in production of 3.4 million tons along with reduced drilling volumes may indicate a considerable increase in the efficiency of new wells. This is a result of implementing new technology and improving the efficiency of drilling contractors. It is notable that Gazprom Neft, unlike other state-owned companies, pursues the strategy of acquiring oilfield services in the market, rather than using its own or an affiliated supplier. Moreover, executives of oilfield service companies speak highly of the level of interaction with Gazprom Neft as a customer purchasing oilfield services.

The decrease in LUKOIL's output and drilling volumes looks rather logical, as the company has been persistently curtailing its drilling program starting from 2014. As noted above, LUKOIL is expected to increase drilling in 2017.

Thus, the drilling dynamics and further growth prospects are quite optimistic. At the same time, independent oilfield service companies are far from being optimistic. Their mood is explained not only and not so much by the volume growth prospects, but by institutional factors.
Key problems of the Russian oilfield services market

Below are the main reasons for the negative background:

1. **Contraction of the independent market of oilfield service companies**

   The share of oilfield service companies directly owned by or affiliated with oil and gas producers increases. This is not a result of competition, but is caused by the persistent strategy of the largest oil producers.

2. **Stronger customers’ positions**

   The consolidation of oil producers, together with a decline in the share of independent oilfield service companies, leads to a situation close to monopsony.

3. **Shakeout of suppliers of auxiliary services to oilfield service companies**

   The continued price pressure on contractors leads to their "lumpenization" and in the future may result in the need for simultaneous significant investments for which there will not be enough resources in the market.

Of course, it is worth noting that the described negative trends are much less visible in companies having long-term relationships with their customer.

As a result, the competition in the oilfield services market is at considerable risk. In the current situation, it is very likely that the market for independent oilfield service companies will undergo a shakeout that will leave intact only high-tech international service providers and low-cost service providers from Russia. However, low-cost service providers will experience increasing pressure from Chinese companies.

At the same time, according to the majority of interviewed executives of oilfield service companies, unfavorable macroeconomic conditions, obsolescence of equipment and low staff qualification do not have a significant negative impact on the industry.
Let us remember what the classic prisoner’s dilemma is. Its main point is that market participants that behave rationally and strive to maximize their own benefit when taken individually, come to a disadvantageous decision and do not achieve the maximum win. However, if the participants had come to an agreement and complied with the accepted conditions, each of them would receive a greater gain³.

In terms of the oilfield services market, this dilemma is interpreted as follows: if we have a competitive and developing market, then oil companies do not get any benefit from acquiring their own oilfield service providers, while oilfield service companies benefit from developing and investing in their business. However, if the market is shrinking and oil service companies are under threat of being taken over by one of oil producers, other oil producers affiliate with oilfield service providers, while oilfield service companies seek to consolidate their relationships with an oil and gas producer or join with another company. In this situation, the company that first leaves the business may do it on the terms that are more favorable.

All this whips up the contraction of the independent market of oilfield service companies.

And together with the constant price pressure from customers and inability to differentiate the product in terms of quality and efficiency, this reduces the attractiveness of investment in the market. We would like to draw your attention to the fact that this situation will lead to a decrease in independent investment in the sector, even in spite of the bright prospects for the total volume of oilfield services purchased by oil and gas companies.

Despite the total dominance of Western companies in the markets of high-tech solutions and equipment, not so long ago Russian companies had the potential to develop technology. But now we have to acknowledge that rapidly developing Chinese companies have come to dominate the low price segment in the market of technological equipment and are actively working in the middle price segment. In such conditions, the entry of Chinese oil service companies into the Russian market will hit Russian companies hard, and the market will unlikely recover from this blow.

Consistent attraction of Asian investments into the Russian oil market will sooner or later result in Chinese oil companies bringing along their own contractors. The question is when and how they will enter the market.

At the same time, one cannot fail to note the growing understanding of the role of innovations by oil companies. They turn their own scientific and technical centers into centers developing new technology. In the classical theory of innovation, its successful implementation requires agents – independent players – experimenters ready to ensure their competitive advantage through innovation by trial and error. It is the critical mass of such players that leads to a technological breakthrough in the industry. Unfortunately, taking into account the specifics of our market, one should not expect that the number and significance of such players will grow.
Further development of oilfield service companies

In the current contradictory situation, oilfield service companies face the ambitious task of long-term survival and growth.

First of all, it is necessary to determine the target strategy for 3-5 years and build your business based on this vision, rather than short-term fluctuations. In our opinion, there are four main strategic directions:

1. **Cost leadership**
   - The cost leadership strategy is not popular among market players. Most likely, it is explained by the high risk inherent in this strategy. The current procurement system and strategy of oil and gas companies allows them to reduce the margin for low-profit services, as well as differentiate suppliers by the purchase price thanks to the structure of the market close to monopsony.

2. **Technology-intensive market segments**
   - Expansion into more technology-intensive market segments is driven by the need for significant investments and is complicated by intense competition in these segments from large international companies.

3. **International expansion**
   - International expansion is the most popular strategic direction. Companies are cautious enough when voicing such plans, though expansion will help diversify their business and ensure its stability and resilience amid volatile economic conditions in Russia.

4. **Preparation for sale**
   - Companies usually do not advertise their preparations for sale. At the same time, the deal with Schlumberger shows that this task is quite complex in itself. We believe that market participants will be actively taking over the least successful players, or rather, their assets.
Regardless of the strategy, companies need free cash flow to achieve their strategic goals. To improve their operational efficiency in the current market environment, companies should first of all:

- Improve labor productivity of core personnel
- Minimize general and administrative expenses
- Improve efficiency of investment projects
- Manage contract margins

At first glance, the current situation requires some government regulation, including such usually popular measures as protectionism and cash injections into individual players. However, judging by previous experience, one may be skeptical about the effectiveness of such measures. Quite often, they either have no effect or freeze inefficiency and cause companies to lag behind in the longer term.

Before discussing any measures, it is necessary to determine the target vision of the future: the desirable market environment, the role of all participants and the position of our companies in the global market.

After discussing and developing the vision based on realistic assumptions, tactical and strategic measures that ensure government support and assistance in development can be worked out.

Oil companies, in their turn, need to assess the situation and analyze their long-term strategy related to procurement of oilfield services. There is a good chance that one of the goals in their long-term strategy will be to ensure reliable supplies of critical oilfield services. A balanced approach to achieving this goal will bring benefits to all market participants in the long term.
Conclusion

The situation in the Russian oilfield services market is quite contradictory and unstable. On the one hand, the market prospects in terms of volumes look promising, but on the other hand, the market is facing pressure from oil companies and shrinking competition. This situation entails more risks for independent players compared to companies affiliated with oil giants. Nevertheless, the most flexible and competitive companies stand a good chance of adapting to this situation and preserving or even increasing their business volumes.
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