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# Global Offshore Projects

2015

*The fall in the oil price over the last year, together with continuing cuts in the E&P budgets of the oil majors and national oil companies, has had – and will continue to have – a significant impact on current and future offshore construction projects.*

## GLOBAL OFFSHORE PROJECTS 2015



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# Dear friends and readers,

At every level in the world, this is a time of change. At the macro level, events such as the unrest in the Middle East and Ukraine, as well as numerous conflicts elsewhere involving national power struggles, are having an increasingly direct impact both on our lives and on the businesses that we are engaged in. At the micro level, the recent dramatic fall in oil prices, to whatever cause it is attributed, has had an immediate effect on the investment decisions currently being taken by the oil majors and by national oil companies relating to offshore exploration and production.

The future for the offshore sector remains uncertain. Given that the demand for oil is likely to remain strong, many expect the investment appetite of the oil majors and the national oil companies to return. But it is unclear when that will happen and what should be done in the meantime.

In this newsletter we look at these issues. We have left the crystal ball-gazing to Gavin Strachan of Firth Petroleum, and are most grateful to him for his informed contribution. His is but one view. There are others which are either more optimistic or more pessimistic. The truth is that no-one really knows how the current changes in the offshore markets will ultimately work out.

Faced with these challenging and uncertain conditions, the first response of the market has been to take stock and, where possible, to defer decisions until the long-term outlook becomes clearer. The ability to impose a change in contractual terms often depends on where offshore projects are being carried out, as well as on the relative bargaining positions of the contracting parties. For now at least, the emphasis is on renegotiation of current terms rather than on the termination of contracts. This arguably reflects the size and maturity of the offshore market, and is a recognition of the fact that the benefits of co-operation, and the ability to create win-win solutions, often outweigh any short-term advantage to be gained by walking away from contractual commitments.

Our newsletter looks at some of the major geographic areas for offshore activity and seeks to identify what we consider to be the important issues. As time passes, priorities might change, but for now we believe that offshore contractors and suppliers can only benefit from access to information about how oil majors and national oil companies are reacting to the current situation in the key areas of the North Sea, Brazil, Mexico and West Africa. We also provide an evaluation of the options available to the industry as it responds to change, and examine how other contractors are dealing with the current challenges facing the market.

We hope that you will find our newsletter interesting and informative.

**Finn Bjørnstad** **Clare Calnan**

PHOTO: Erik Burås

PHOTO: Nina Rangøy

# THE OIL PRICE FALL AND THE IMPACT IT IS HAVING ON DRILLING

BY GAVIN STRACHAN [1]

Many western oil companies were already in trouble when the oil price began its desperate fall from a year-high of USD 115 a barrel in June 2014. As 80% of the world's oil and gas was controlled by state oil companies, western companies had turned to higher-cost and more technically challenging oil from deepwater and shale. But they found they were being squeezed by rapidly rising costs and, despite their investment, by a decline in their production. Between 1999 and 2012, spending rose by 374% while oil production rose by only 24%, and in the six years to 2012 the majors' share of production declined 18%.

## DEEPWATER AND LAND RIG MARKETS PARTICULARLY AFFECTED

The downturn accelerated as a result of the recent oil price fall, and now affects all parts of the world and all rig types. Although many OPEC members are able to survive better in a low oil price environment in the short term even national oil companies are reducing their levels of activity. The highest profile drilling market to suffer is global deepwater, where the drop in utilisation is exacerbated by rigs coming off contract early and by an increasing supply of newbuilds. The corruption scandal in Brazil, where Petrobras, a major user of deepwater rigs, has reported financial wrongdoings contributing to a USD 22.7 billion loss from assets, has added to the paralysis in activity.

The oil price collapse is particularly hitting onshore activity in the USA, where shale drilling predominates. Just as in the offshore market, the reductions in rig use have been indiscriminate of rig performance and capabilities, and units on long-term contracts are being terminated early. November 2014 saw a peak of 1,859 land rigs working in the USA; as at 4 April, the US land rig count stood at just 993.

## OIL PRICE FALL – THE RESULT OF INCREASED SUPPLY FROM THE USA AND DIMINISHING DEMAND

The oil price fall was caused by the sharp increase in supply from shale production in America and a diminution in demand from Europe and particularly China, where economic growth was throttling back. Between 1981 and 1984, Saudi Arabia experienced the very negative impact of acting as a swing producer. Its production fell from 9.6 million bbls daily to 3 million, and the economy suffered accordingly. This led OPEC to decide that countries other than Saudi Arabia should take the brunt of production cuts to stabilise prices, leading to the present impasse.

## MAJORITY OF PRODUCING FIELDS SURPRISINGLY RESILIENT TO LOW OIL PRICES

The oil price at which various fields are viable is much discussed. However, Wood Mackenzie has analysed 2,222 fields, comprising 75 million bpd of global production, and concluded that, at an oil price in the high-USD 30s a barrel, tight oil is not viable. It also observes that turning bitumen fields on and off is complex, and that stopping steam injection means a long and expensive restart. As much of the cost of production is in fuel powering extraction, lower oil prices also mean lower operating costs.

At USD 40 a barrel, Wood Mac believes that 1.5 million bpd is vulnerable, of which one million is from US land "stripper" wells which produce only a few barrels daily at costs of between USD 20 and USD 50. At USD 45 a barrel, only 400,000 bpd globally is cash-negative, half of which is conventional onshore US production. But being cash-negative does not mean that production is stopped. Halting conventional, rather than shale, production is often irreversible and, when it is, offshore

platform costs are subsidised by links to other fields. Oil companies may prefer to work at a loss for a period rather than decommissioning a field costing hundreds of millions.

At USD 50 a barrel, just 190,000 bpd or 0.2% of world supply is cash–negative, affecting mainly some fields in the USA and the UK. Overall, Wood Mac's analysis suggests that, at current prices, little production will be shut in, and accordingly we could be in for a sustained period of low oil prices.

### SHALE OIL COULD BECOME SWING PRODUCER AND SET CEILING ON PRICES

The oil price drop may cause the market to rebalance in ways that challenge traditional thinking. The IEA, the Paris-based think-tank for western governments, believes that low oil prices will end fairly soon, but going back to the dizzy heights of USD 100 or more is probably not achievable. US shale production will increase as oil prices recover, rising to 5.2 million bpd in 2020 compared with 2014 production at 3.6 million bpd. Extracting shale oil, while expensive, can be started and stopped quickly, thereby preventing big swings in availability and providing a ceiling on prices.

*The downturn accelerated as a result of the recent oil price fall, and now affects all parts of the world and all rig types.*

### WHAT DO LOW OIL PRICES MEAN FOR THE INDUSTRY?

- Cost-cutting is intense. At USD 60/bbl, costs need to be cut by USD 170 billion or 37% to maintain debt at 2014 levels.
- Exploration, including that by national oil companies, is declining sharply in all areas.
- New project investment is being hit, leading to a downturn in development drilling.
- Distressed sales provide a buyer's market this year. Some companies will have little choice but to sell - unable to achieve cuts in the discretionary spending required to balance their books.

### FINANCIAL RAMIFICATIONS OF LOW OIL PRICES

- The financial performance of oil companies and service companies alike will deteriorate in 2015.
- The fall in revenues is exacerbated by higher debt. Debt has risen 20% (USD 53 billion) for 46 international oil companies since 2010.
- The cost of new capital for smaller companies will rise sharply. Asset write-downs will lead to higher leverage ratios and, for some, increased financial stretch.
- Refinancing could prove difficult and covenants based on reserves, cash flow, and market cap ratios could come into play.

### WHAT DO LOW OIL PRICES MEAN – FOR THE LONGER TERM?

- USD 112 billion of investment decisions are vulnerable to being pushed out of 2015, and a further USD 145 billion in 2016.
- Only the most economically robust projects will proceed, leading to a tighter oil supply/demand balance in a few years.
- Large-scale consolidation is more likely than at any time since the late-1990s. History shows that value through M&A is largely driven by commodity prices. For buyers who believe in long-term oil above USD 80-90/bbl, 2015 will be a year to go long.

### NEED FOR DRILLING TO TAKE PLACE IN THE FUTURE

Although the current level of activity is low, longer term we need to start drilling again - and on a big scale. The global decline from existing fields in production is 5% a year, so by 2030 over half of existing global production will disappear and needs to be replaced. Although US shale output will rise, it will not be enough to meet additional 2020s global demand. The world population continues to rise inexorably and increasingly people live in cities, adding to energy demand. An enormous amount of money and effort needs investing to find an additional 50 million bpd of new production. If these investments are not made relatively soon, production growth in the 2020s will not take place.

OPEC members, in due course, and western oil companies, as soon as possible, both need higher oil prices. OPEC believes that the oil price will rise in a few months. Many western oil companies, such as ENI, believe that the oil price will stay low for 12 to 18 months and then rise, while, perhaps sensibly, BP is budgeting on the price remaining low for three years. As we have seen, the IEA thinks that the oil price could bump along at perhaps USD 75 for many years as American shale production takes on the mantle of swing producer.

Come what may, as oil company budgets run from January to December and are set towards the end of each preceding year, it is unlikely that the drilling market will improve in 2016. But it might in 2017.

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# THE FUTURE FOR OFFSHORE CONSTRUCTION PROJECTS

THE FALL IN the oil price over the last year, together with continuing cuts in the E&P budgets of the oil majors and national oil companies, has had – and will continue to have – a significant impact on current and future offshore construction projects.

The majority of offshore unit construction is undertaken at shipyards in the Far East and, in particular, in China, Korea and Singapore, and it is here that the impact of the current downturn in the market will be greatest. For many years, offshore contracts were largely profitable, with the delivered units entering a market where employment contracts were plentiful and could command healthy day rates. This in turn led to more shipyards entering the offshore construction market and more buyers ordering units which were not linked to specific employment contracts. By way of example, in the jack-up market, the average number of units delivered between 2006 and 2013 was 19 per year. (By way of contrast, Clarkson's estimates that, in 2015, 67 jack-ups will be delivered, of which two-thirds are being built by Chinese shipyards).

In this environment, competitive pricing became market standard, with favourable payment terms (such as 10% of the contract price payable as a first instalment and the remaining 90% payable on delivery of the unit) being offered by shipyards or demanded by buyers. Likewise, many contracts were placed through special-purpose vehicles (SPVs) in circumstance where the yards had either limited or no rights of recourse in the event of a buyer default. Whilst this fuels growth in the market, it also potentially poses considerable risks to the shipyard when economic events conspire to place substantial pressure on the buyer's ability to secure take-out financing and to take delivery of the offshore unit.

With day rates for all offshore units falling over the last few months, and with softening of the employment market expected to continue for some time to come, it is not surprising, given the oversupply of all such units, that construction projects are coming under increasing pressure. This pressure is at its greatest where the buyer is approaching the time for delivery and the initial employment contract is proving difficult to secure. In these circumstances, both the shipyard and the buyers are likely to consider their options.

If the buyer does not want to take delivery of the offshore unit, the obvious option is to look to cancel the contract. However, cancellation is not always straightforward, particularly where either the reason for delay is disputed or there is a question as to whether the defects in construction are sufficient to justify a rejection of the unit. Should the buyers get it wrong, they may open themselves up to a claim not just for the first instalment (which even at 10% of the contract price is likely to be substantial) but also for damages for breach of contract. This may be considered a minimal commercial risk where the buyer is a SPV with limited assets, and the shipyard has no additional security. However, the offshore market is much smaller than the marine market and a buyer intentionally following this course may be reluctant to do so where there is a reputational or commercial risk associated with abandonment of the construction contract.


PHOTO: istockphoto

Should the buyer fail to take delivery of the unit, the shipyard will be left with a highly specialised asset of diminishing value and a limited ability to claim damages for the losses it has suffered. The shipyard will be anxious to manage the project in such a way as to avoid finding itself in a situation where cancellation of the construction contract is possible. Relying on legal rights and seeking an award of damages is an expensive and lengthy route to follow, even assuming that the shipyard is ultimately able to successfully pursue a claim and find assets against which to enforce any award. Piercing the corporate veil to enable enforcement against investors and shareholders is far from straightforward and, even where this can be done, physical assets have to be located against which enforcement can be made.

In view of these difficulties, although "default" situations may arise, the more common solution adopted in the offshore construction market is for both parties to renegotiate the commercial terms of the contract to find a mutually beneficial outcome. Whilst compromises are required, shipyards and offshore purchasers are adept at finding creative solutions to keep contracts in place so that they can both ride out any economic downturn that threatens the contract. It is too early to say whether this will be the pattern that will be followed in the current downturn, and much will depend on how long the stall in drilling activity is predicted to last. However, and at least for now, most people are confident that drilling activity will increase, although there is a great deal of uncertainty as to when that will happen and where it will start first.

It is clear, though, that the current market conditions are giving rise to more disagreements between shipyards and buyers. In better times, such issues might be more easily resolved, but there is perhaps now a greater reluctance to give up "positions" easily. Some of these disagreements may end up in arbitration or court proceedings and both parties will need to consider carefully what steps they take, and what written correspondence they enter into, in order to avoid prejudicing their contractual position in relation to ongoing construction projects.

There are currently few reported cancellations and, in some cases, shipyards have already agreed terms to defer delivery of certain units. Some rather creative solutions are being explored, such as the one adopted by Ocean Rig, which has agreed with a shipyard to convert an order for two drillships into tankers. This suggests that, for now, most participants in the offshore construction market are buying time and that both shipyards and buyers see the benefit of working together to find solutions to weather this particular downturn. This is not to underestimate how tough or costly the negotiations currently taking place are, but at least for the time being we are not seeing a large number of cancellations and buyer defaults similar to those which took place in marine construction in the financial crisis in 2008. Some hope can perhaps be drawn from that.

# NORTH SEA

## – the efficiency of every dollar

Reductions in the cost of exploration and production activities have been top of the agenda for oil companies on both the Norwegian and UK side of the North Sea for several years. Recent government reports, such as the 2012 Reiten Report on the Norwegian Continental Shelf (NCS) and the 2014 Wood Review on the UK Continental Shelf (UKCS), have reinforced the view that standardisation, removal of regulatory barriers and collaboration between industry participants are of paramount importance in order to maintain profitability and attract future investment in the North Sea. The oil price fall has further emphasised the need to increase the efficiency of every dollar spent as soon as possible, and oil companies operating in the North Sea have already started to reduce their investments in new projects and to take other measures to protect their bottom line.

### AWARDS OF EPC(IC) AND PROJECT CONTRACTS

In 2013-2014 the offshore service industry saw a number of large EPC(IC) contracts for new projects in the North Sea awarded to Asian yards. The fall in the oil price has crystallised the choice facing the oil companies between either cheaper Asian suppliers or more experienced (but perhaps more costly) local contractors. This is a trend which may continue, but it has risks. With increased pressure to cut costs, both new and established contractors need to be aware of the particular regulatory requirements governing the NCS and UKCS (and the differences between them) and to arrive at a price and contract terms which strike a reasonable balance between risk and reward. This is particularly important when tendering for new types of services, such as decommissioning projects which are expected to generate substantial work for the offshore service industry in the North Sea.

### SUSPENSION OF DRILLING CONTRACTS

One of the main cost elements of offshore E&P activities is the rate of hire of drilling units. Since the fall in the oil price, there have been several examples of oil companies in the North Sea suspending operations under their drilling contracts, including Statoil's recent suspension of certain drilling contracts with Saipem, Songa Offshore, Transocean and others. The right to suspend the work of the drilling contractor is not part of Norwegian or English background law, which typically governs drilling contacts on the NCS and UKCS respectively and thus can only be exercised where there is a specific right to suspend in the drilling contract. The existence of such suspension rights raises some important, considerations for drilling contractors: (i) whether the oil company can suspend drilling services only in particular circumstances or generally at its discretion; (ii) the notice period for suspension during which the regular operating rate is payable; (iii) the rate the oil company is obliged to pay during the suspension period, and; (iv) whether the drilling contractor is entitled to terminate the contract where the suspension continues for a certain period.

Even if the wording of the drilling contracts seems at first glance to provide a general right for the oil company to suspend its drilling contract with limited compensation to the drilling contractor, a more detailed analysis of the relevant clauses may show that there are restrictions on the oil company's rights in this respect.

Drilling contracts are typically agreed for either a number of wells or for a fixed period. Consequently, the employment of the rig is at the risk of the oil company, and the contractor earns its compensation based on time and on the actual performance of the rig. Both Norwegian and English law will therefore require clear contractual provisions to allow the oil company to suspend the drilling contract. Any ambiguity in this


PHOTO: John Maravelakis

respect should be interpreted against the interests of the oil company.

Contractual provisions stating that the suspension must be "temporary" can be interpreted as precluding the oil company's right to invoke the clause where in reality this would amount to a cancellation of the remaining part of the drilling contract. However, this raises the question of when a suspension is deemed to be a cancellation, and this often needs to be considered in relation to the total duration and remaining term of the relevant contract.

Where the period of suspension is undefined and is for the oil company's convenience, the situation is more correctly described as a "negative change order" or as a partial cancellation. Drilling contracts normally include provision for such situations, which give the drilling contractor protection by entitling it to full cost compensation. It is therefore questionable whether an oil company may in fact "lay-up" the drilling unit for whatever reason by invoking suspension when the contract contains specific provisions for negative change orders or partial cancellation.

## REVISED TAX REGIME ON THE UKCS

Not all cost-saving measures have a negative impact on the profitability of oil companies and the oil service industry operating in the North Sea. Taxation can play a key role in protecting or promoting investments. The UK Government recently announced certain revisions to the tax regime applicable to operations on the UKCS which are designed to encourage investment and improve the commercial viability of less profitable fields. These measures are together worth an anticipated £1.3 billion and include the following:

For investment expenditure for projects in both new and existing fields after 1 April 2015, oil companies will be entitled to deduct from their adjusted ring-fence profits an amount equal to 62.5% of investment expenditure incurred in respect of a field, when calculating their liability under the Supplementary Charge regime. It should however be noted that the types of investment expenditure falling within the regime are yet to be clarified.

Furthermore, the Government announced a reduction in the Supplementary Charge on North Sea oil revenues from 30 % to 20 % with effect from 1 January 2015. When added to the Ring Fence Corporation Tax (RFCT) on UKCS production of 30 %, the headline tax rate on revenues from oil and gas fields not liable for Petroleum Revenue Tax (PRT) has thus fallen from 60% to 50%.

The PRT, which is chargeable in respect of revenues from fields for which consent for development was obtained before 16 March 1993, has also been reduced from 50% to 35%, bringing the maximum marginal rate down from 81% to 67.5%. This measure is designated to target mature oil fields which typically have high operating costs, and the aim is to ensure that such fields remain commercially viable.

## SUMMARY

The falling oil price and the cuts in E&P expenditure will be felt in the North Sea, as in other areas of drilling activity. This is likely to increase the speed at which efficiencies are introduced. Cost-saving measures will continue to be implemented by the oil majors both in terms of the construction of units at shipyards and the introduction of greater flexibility in operating contracts through improved rights for suspension of work and early termination. The efficiency of each dollar spent will continue to be a primary driver in many of the investment decisions made concerning further exploration and production activities in the North Sea.


# BRAZIL

## – where the low oil price is the least of the problems

WRITTEN IN COLLABORATION WITH
DANIELA RIBEIRO AND TIAGO SEVERINI [1]

Analysts report that Petrobras, the Brazilian state-owned oil and gas company, accounts for approximately 10% of all global offshore investments. It is also the world's largest consumer of offshore services relating to deepwater drilling, including ultra-deepwater rigs and drillships, subsea trees, flexible pipes, pipelaying vessels and offshore support vessels. The result of this ambitious investment programme, which has been implemented over several years, is that there are a number of significant oil service contractors who have a heavy exposure towards Petrobras, and a substantial percentage of their contractual backlog is linked to contracts that have been concluded with the Brazilian oil major.

These large investments, together with the growth in offshore activity over the last decade, have seen costs continue to spiral in Brazil, which in turn has placed local content requirements, which are an important and necessary part of all offshore activities carried out in Brazil, under considerable pressure.

*Reportedly, a total of 24 companies have been suspended from tendering for Petrobras contracts over the next 2-5 years.*

The fall in oil prices comes at a time when the issues facing the offshore industry in Brazil are already very challenging. The legal modification of the taxation of charter agreements, in force since January 1st, 2015, has in some cases increased the applicable tax burden through effectively rearranging the split between charter and service payments. Add to this the explosive cocktail of the Petrobras corruption scandal, which erupted in the wake of the Car Wash Probe in the autumn of 2014, and it is clear that events in Brazil are of much greater concern than some of the macro-economic issues affecting the wider international offshore industry.

The Petrobras scandal started in November 2014, with PwC refusing to sign off on Petrobras' third-quarter results. Following this a number of Petrobras directors and personnel, together with some offshore contractors, were investigated and, in some cases, charged with corruption. January 2015 saw a change in the main management of Petrobras, but this was not the end of the company's troubles because, in March 2015, its credit rating/investment grade was downgraded by Moody's.

At the same time, a number of major (mainly Brazilian) oil service contractors were placed on a Petrobras "blacklist" and their contracts with Petrobras suspended. Reportedly, a total of 24 companies have been suspended from tendering for Petrobras contracts over the next 2-5 years. This includes SETE Brazil, which has 28 long-term contracts with Petrobras and a number of units under construction both inside and outside Brazil. Legal action has also been initiated and a number of lawsuits, in Brazil and overseas, have been launched or threatened as a result of the scandal.

Throughout the corruption investigations Petrobras has continued to maintain that its cashflow and operational income are sound and that it intends to continue to make payments as usual under existing contracts. However, recent developments, and in particular the company's reduced credit rating, have led to concern that Petrobras may not be granted continued access to debt markets to the extent that it requires in order to maintain its investment programme. This fact, in combination with the low oil price, may make it difficult for Petrobras to meet its capital investment targets.

Offshore contractors and oil service suppliers in Brazil have already experienced attempts by Petrobras to re-negotiate rates and contract terms. In addition there have been cases where contracts have not been extended or where option periods have not exercised as expected. Petrobras' preferred option is often to seek to enter into new contracts on what it considers to be better commercial terms.

These negotiations and discussions are still mainly commercial and take place within the framework of an existing contract relationship. Petrobras does not have rights to suspend work or to cancel or terminate contracts for its convenience during the agreed fixed term without paying compensation to the contractor, although termination clauses are wide and contain "catch-all" provisions. So far this has not been the way in which Petrobras has sought to enforce its rights. But the worldwide crisis in the oil sector, cooling down what not so very long ago was a booming market for offshore equipment, has been enough to persuade some of Petrobras' contractors to read the writing on the wall. Some have already started to voluntarily re-negotiate old contracts with Petrobras to secure new daily rates. In these troubled times, doing something is often seen to be better than doing nothing.

But the picture is not all gloomy. As a result of Petrobras' lack of financial capacity and its difficulty in raising sufficient debt funds, there is now a possibility of amending the Pre-salt law so that Petrobras will no longer be the sole operator. If this amendment is approved and comes into effect, it will create opportunities for major international oil companies in Brazil with important roles in the Pre-salt, such as BG, Total, Shell and also Statoil. So although the Brazilian market may be suffering in the short term, recent developments may lead to increased competition in the Brazilian E&P market, which in turn should be more beneficial to offshore suppliers in the long run.

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# MEXICO

## – long-term gain but short-term pain

WRITTEN IN COLLABORATION
WITH ENRIQUE GARZA [1]

Following the announcement in 2013 by Mexico's national oil company Petroleos Mexicanos (PEMEX) of its commitment to increase oil and gas production in the long term by developing a sustainable marine and offshore industry, Mexico has increasingly become the focus of attention of E&P and oil service companies. To support this investment and development drive, the Mexican government has set out a programme for the ambitious reform of the country's energy laws and regulations. Although the long-term development of Mexico's energy resources is unlikely to be diverted by the current market conditions, there is no doubt that offshore contractors will bear the brunt of the impact of these conditions in the short term as Pemex seeks to exercise its power to terminate or renegotiate contracts.

### MEXICAN ENERGY REFORM

Mexican Energy Reform began with an amendment to the Mexican Federal Constitution, which was introduced on 20 December 2013. This created new industry structures in oil, natural gas and electricity, the purpose of which is to promote an increase in private investment in these sectors, whilst at the same time enabling the development of natural resources within a regulatory framework that promotes rather than hinders economic growth. More laws and regulations were introduced in 2014 to further enhance and promote this development. Although the process is slow, the direction of the reforms is positive and they have created important opportunities for private investors in the offshore market and, in turn, new markets for offshore contractors and the oil service industry.

The long-term future may see an increasing number of international oil companies becoming directly involved in the development of oil and gas assets in Mexico, either together - or in competition - with PEMEX. This type of E&P activity is also likely to spur opportunities for international oil service companies, particularly those with a track record for assisting oil companies in other jurisdictions. PEMEX itself is also expected to broaden the scope of pre-approved international contractors for its tenders.

### PEMEX CONTRACTS SUFFERING FROM THE OIL PRICE FALL

PEMEX still dominates exploration and production activities in Mexico but, not surprisingly, the country is not protected by the economic macro developments currently impacting oil exploration and production activities worldwide. The oil price is falling and, with it, the appetite for investment in new or challenging drilling activities. The pressures on PEMEX created by falling revenues and reduced investment budgets is intensified as a result of the fact that it is no longer a decentralized entity of the Mexican government but rather an "Estate Productive Enterprise" with a constitutional mandate to become a profitable enterprise.

To some extent, PEMEX may have a better-equipped toolbox with which to weather this particular storm compared with some other oil companies. Most of PEMEX's current service contracts have been entered into pursuant to


PHOTO: Istockphoto

binding administrative contracting norms which were issued by PEMEX's board of directors on 6 January 2010. These set out the minimum terms that have to be included in contracts for the acquisition, leasing, works and services of substantive activities of productive nature. Consequently, it is common to find early termination clauses in PEMEX contracts which grant PEMEX the right to early termination by giving the contractor 30 days' prior notice and paying (i) all hire accrued until the date of termination, (ii) any mobilisation fee and (iii) an indemnity of 3% over the remaining value of the contract (if PEMEX exercises its right to early termination before 70% of the contract term has elapsed) or no indemnity (if the termination is requested after 70% of the contract term has elapsed).

These are much more extensive termination rights than those normally found in international service contracts for the offshore industry. Even if PEMEX is obliged to pay 3 % of the remaining contract value, this may be small compensation to a drilling contractor for the loss of a long-term contract for employment of a rig or vessel – particularly if such contract was the basis for the financing of such rig or vessel.

Following the recent fall in oil prices, Pemex has started to ask several suppliers of vessels, drilling rigs and drilling modular equipment for early termination of leasing and chartering agreements and for a reduction in the daily rates of the contracts that will remain in place. PEMEX's negotiations with its suppliers are ongoing, and a significant reduction in the number of vessels and rigs hired by PEMEX and in the daily rates paid by PEMEX can be expected.

A new law regulating the activities of PEMEX has been enacted under the Mexican Energy Reform programme and new administrative contracting norms are expected to be introduced. These new norms may amend the minimum requirements for termination clauses in PEMEX future contracts, but such amendments will be of little comfort to those suppliers currently facing difficult renegotiations of their current contracts with PEMEX.

## SUMMARY

The long-term outlook in Mexico is positive because the country is embarking on a programme of reform which is likely to result in substantial investment in the exploration and production of its natural resources. The recent pressures on E&P activity will undoubtedly slow down this development and in the short term the favourable termination terms in PEMEX contracts will inflict a great deal of pain on offshore contractors. Those that are able to weather this period may well find themselves well-placed to take advantage of the new opportunities when they come, but this is likely to be of small consolation to contract negotiators who are currently trying to persuade PEMEX to maintain their contracts in place.

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# WEST AFRICA

## – a low-cost haven for offshore suppliers in search of replacing a diminishing contract backlog?

WRITTEN IN COLLABORATION WITH
MARCO CARDOSO AND VASCO CARVALHO MARQUES (1)
AND SOLA ADEPETUN (2)

The breakeven cost for an average exploration project in Nigeria is reportedly about US$ 40 per barrel, which is substantially lower than the costs of exploration in e.g. the North Sea. Consequently, when the oil price started its dramatic decline last year, there was some speculation that the oil majors would look to relocate to the West Coast of Africa those offshore units that were becoming idle in the North Sea, thereby easing the impact of the current market conditions.

Based on recent reports from countries such as Angola and Nigeria, however, such speculation appears to be wide of the mark. Oil companies are delaying investment decisions and postponing projects and, in common with most other places around the world, commercial discussions are taking place with a view to delaying start-ups and deliveries of assets, to reduce agreed rates and prices and to shorten contract terms. The prevailing view in West Africa therefore appears to be that oil service suppliers will need to bear their share of the reduced income burden resulting from the low oil price and that they too will be forced to embark on cost-cutting programmes, together with the oil majors, in order to remain profitable.

Although the national oil companies, such as Sonangol in Angola, and the Nigerian National Petroleum Company in Nigeria, play a key role in the Angolan and Nigerian markets, all the large oil majors are also there, often as operators. In many cases these oil majors conclude contracts based on their own standard terms, which are often governed by English law. Whether or not the terms originally agreed between the parties allow the oil company to impose a decrease in rates during the original contract term, a right to suspend services for a period of time at a low rate and/or to cancel the contract without full compensation, may vary from contract to contract and from project to project. It is fair to say that such clauses are relatively unusual and that both oil companies and their contractors are likely to be reviewing their contracts for possible commercial opportunities or to protect their interests.

In Angola, as opposed to Nigeria, the parties should be aware that the contracts are likely to remain subject to forthcoming legislation intended to be applicable to the said contracts. The parties need to commercially agree upon contractual tools to protect them, to the extent permitted by law, against such unexpected provisions and rules, which may allow the oil company the possibility to cancel an unfavourable contract.

In any event and in both markets, the various players are dependent on each other for future business. Moreover, the oil majors are very adept at using the prospect of future tenders as leverage in negotiations with offshore suppliers to find commercial solutions in connection with expensive contracts where rate reductions are needed.

Both the Angolan and Nigerian economies are largely dependent on the income from national oil production. Foreign exchange reforms have been mooted in Angola for a number of years, along with tax changes and amendments to capital investment regulations. It remains to be seen how the extent and progress of these reforms will be affected by changing market conditions. Further reforms, in particular in the capital investment area, are already expected to be put in place shortly.

In Nigeria, whilst reform is under discussion, it remains to be seen what effect the recent election and change of president may have on the strategy and development of the country's E&P sector. The challenge for the governments in both states will be to continue to find ways to balance the need to seek compensation during periods when there is reduced income from oil production against a continued dependency on attracting foreign investors and players.

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