Aberdeen & Grampian Chamber of Commerce

Oil and Gas Survey

28th Survey: May 2018

Aberdeen & Grampian Chamber of Commerce

University of Strathclyde Glasgow

KPMG

Survey context

This latest survey of activity and sentiment in the oil and gas industry offers further evidence that the sector continues to remain resilient in the face of a challenging business environment.

The sharp cost cutting and efficiency measures undertaken over the past two to three years – coupled with reforms to the fiscal and regulatory environment – has led to a sector that is now more competitive, diversified and innovative.

Unit operating costs are around half of what they were back in 2014 even though production has increased.

The sector has of course been boosted by the sustained rise in the oil price – with Brent Crude now trading at close to $70 compared to below $50 just last summer. This has helped to support some new capital investment after years of sharp cut backs.

All of this is reflected in a further positive upturn in the results to this survey.

Almost 2/3 of contractors reported being more confident now than this time last year with seven in 10 believing that next year will be even better. Encouragingly, the trend in exploration work – which had been negative since the spring of 2014 – returned to positive balance.

Of course, the sector continues to face some not insignificant short-term risks and uncertainties. Whilst some progress has been made with regard to the transition arrangements for the UK's withdrawal from the EU, we do not yet know the long-term implications for regulation, access to markets or the supply of skilled labour. Ongoing geo-political uncertainty - including US-China trade relations – are likely to continue to have an impact on short-term prices.

But the sector – arguably more than any other in the UK economy – is well aware of the importance of focussing upon the long-term. Increasingly the sector is focussing upon the next generation of development projects and how best to use new technologies to enhance recovery and to reduce costs.

This will ensure that the sector continues to make an important contribution to the Scottish and UK economies for years to come.

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Sponsor's foreword

KPMG are delighted to once again sponsor Aberdeen & Grampian Chamber of Commerce's Oil and Gas Survey. The insight that the survey brings has been invaluable to companies, advisers and commentators alike, and this, the 28th survey, continues to provide us with a direction of travel for the sector and outlook for the UK Continental Shelf. It is heartening to note the rising confidence that respondents have in the UKCS with nearly 75% of the firms forecasting an increase in business optimism in the region.

While structural change, focused on cost reduction and operational efficiency, has had an impact on financial performance, the steady rise in the price of crude has resulted in some major operators recently reporting higher earnings, with the results for Q2 2018 promising to unveil even stronger cash flows for the upstream oil and gas sector. With crude now at a four-year high, results for Q2 2018 promise to unveil even stronger cash flows for the upstream oil and gas sector.

However, there has been a continued backdrop of restrained investment and so the oil market is noticeably tighter and increasingly vulnerable to geopolitical events such as the change in US position on Iran. Rising prices combined with reserve replacement considerations will, we believe, undoubtedly lead to an increased level of final investment decisions; whether or not investment levels will be strong enough to meet strong global demand growth and potential supply disruptions is yet to be seen.

The level of energy demand remained a very important concern for more than three quarters of contractors who responded to the survey. However, firms are telling us that whilst commodity prices remain an important factor that may constrain their activities, the extent to which it might hinder growth has lessened significantly. Perhaps a sign that firms now consider themselves to be suitably agile in terms of their business structure to manage fluctuating commodity prices?

The industry generally continues to be more positive. Recovery in market sentiment is steady but there remain challenges in terms of skills shortages and cash flow particularly for SMEs. It is concerning that the survey is telling us that lengthy payment terms continue to be a problem for these companies, creating liquidity issues and potentially hindering growth. Against a back-drop of the UK's Payment Practices and Performance Reporting ('PPPR') regulations and Oil & Gas UK's Supply Chain Code of Practice, we need to see a significant shift in culture towards paying to faster terms if the sector as a whole is to flourish.

As confidence returns to the sector, the lessons learned from the last four years need to be front of mind and innovative thinking needs to remain at the fore. A return to the traditional way of thinking towards exploration and production (E&P) activity will not deliver the long term benefits the industry needs and changes in behaviours and culture of the industry are crucial for securing the sector's future vitality.

Moray Barber
partner, KPMG

Chamber viewpoint

Welcome to the results of the 28th Aberdeen & Grampian Chamber of Commerce Oil and Gas Survey, the longest running report of its kind in the UK. We are pleased again to be partnering with Fraser of Allander Institute and KPMG to bring these insights to the marketplace.

Fully independent and delivered for and on behalf of our members, the survey seeks to analyse short and medium-term trends in exploration and production, decommissioning and other related activities both in the UK and international markets.

It has been almost four years since the major downturn in oil price and, although the recovery from this remains patchy, our latest survey reveals that confidence levels are continuing to grow.

During the six months to April 2018, almost two thirds of contractors reported being more confident about the current business situation compared to a year ago. This net balance of 56% is greater than the 39% recorded in the previous survey and is in fact the highest figure since spring 2013.

Based on the fact that:

- 41% of businesses are now working at or above optimum levels
- Almost three quarters of firms are forecasting profit increases in 2018
- And seven in 10 firms expect to see a further increase in business optimism surrounding the UKCS sector in the months to come,

it appears that contractors, as well as licensees and operators, are optimistic that this positive trend will continue into the year ahead.

There is also good news across E&P activity. A net of 20% of contractors have expressed a rise in the value of production-related work in the North Sea compared to -4% six months ago. This is the first time since autumn 2014 that this trend has been positive and almost half of firms are forecasting further increases in the year ahead.

And for the first time in four years, we are also seeing positive figures for exploration with 21% of contractors forecasting an increase in the value of UKCS activity over the next 12 months- a great sign that the pipeline of future work is beginning to open up again.

In terms of employment, the rate of reduction at operator companies continues to slow while contractors reported a 0.2% increase since March 2017 with growth of 3.9% forecast for the coming year. With this in mind, our next survey will contain a section focusing on the issues of recruitment, retention and potential skills shortages.

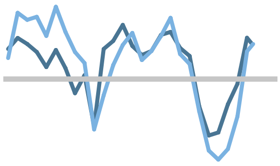
In summary, the oil and gas sector has faced up to some significant and structural challenges over recent years and is beginning to emerge fit for the future. Companies across the eco-system have and continue to adapt and adjust their approach to ensure the industry's future viability with collaboration and co-operation as well as the implementation of new technology to improve efficiency being cited.

It does appear that a corner has been turned but we must avoid complacency. The future strength of the sector depends on operators, contractors and suppliers continuing to work together in the new way as the climate continues to improve. A steady recovery, not a return to boom and bust is what is required.

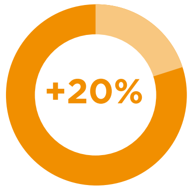
What is clear is that oil and gas will remain a key contributor to the North-east of Scotland and UK economies for many years to come.

Russell Borthwick
chief executive

Key findings

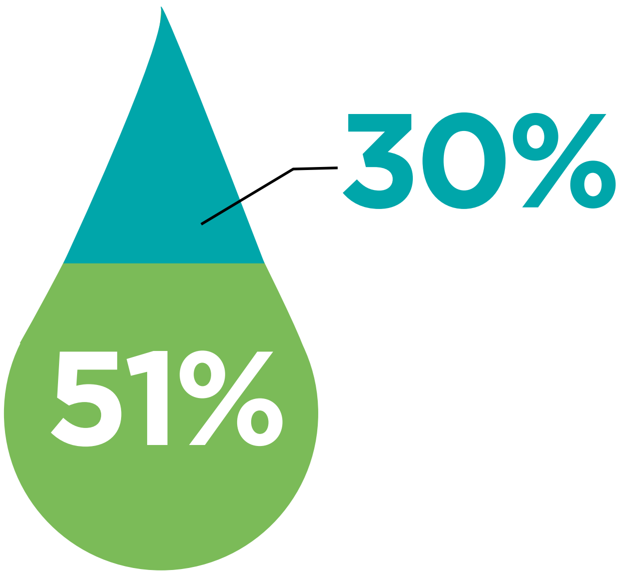


Contractors' confidence in the UKCS continues to improve with a net balance of +56% compared to +39% six months ago



A net of +20% expressed a rise in the value of UKCS production related activity, the first positive net balance since autumn 2014

Optimism in the international oil and gas sector increased for 61% of contractors and 67% are forecasting a further rise over the next twelve months

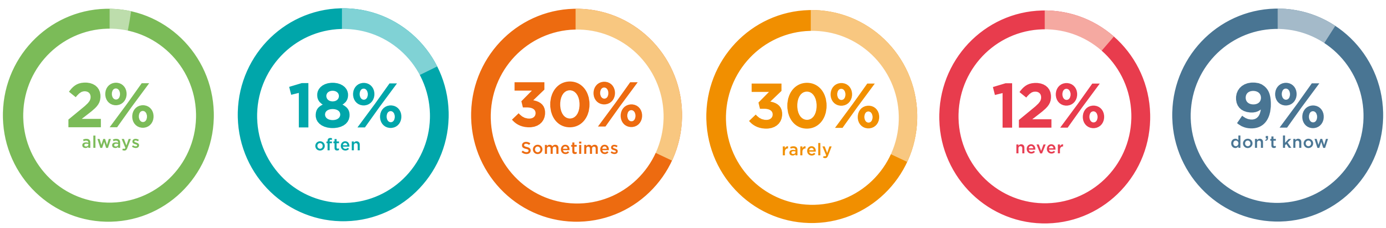


30% of contractors have increased investment spend in the UKCS in the past 12 months with 51% expecting to increase investment over the next two years

41%

(the highest figure since autumn 2014) of contractors are working at, or above optimum levels in the UKCS

Firms were asked to what extent they felt that the industry consistently adheres to the 30-day payment terms outlined in the Oil & Gas UK Supply Chain Code of Practice:



Percentages may not add up to 100% due to rounding

A net of +3% of contractors reported a rise in the value of exploration related activity – the first positive result recorded since this question was introduced in spring 2014

In the last 12 months contractors have experienced a

0.2%

increase

operators

5.4%

reduction in their UK-based workforce

A net of

+75%

of contractors are expecting to increase investment in developing new markets over the next 24 months

Contractors vacancy rate:

5.89 per 100 jobs

(up from 2.7 per 100 jobs six months ago)

70%

of firms are forecasting an increase in profits in 2018

NEXT THREE TO FIVE YEARS

35%

The availability of R&D funding influenced the decision to invest in R&D in the UK for 35% of firms

78%

78% of contractors are either possibly or definitely expecting to be more involved in decommissioning activity in the next three to five years

Business optimism

United Kingdom Continental Shelf

It has been almost four years since the downturn in the oil price and although parts of the sector are still beset by sluggish prices and high inventory levels, contractors in this current survey continued to report a rebound in business confidence, with the upward trend enjoyed since the November-April 2017 survey continuing.

This latest survey reveals that almost two-thirds (64%) of contractors reported being more confident about the business situation in the oil and gas sector compared to one year ago and only 8% indicated being less confident. This net balance of plus 56% is greater than the plus 39% recorded in the previous survey and is the highest net balance recorded since spring 2013.

Contractors are optimistic that this upward trend will continue into the year ahead with seven in 10 firms (71%) forecasting a further increase in business optimism surrounding the UKCS sector and only 4% expecting the outlook to worsen.

Similarly licensees and operators also reported a rise in optimism, and furthermore looking to the year ahead a net balance expect this upward trend to prevail.

> **For the first time since 2013, the gap between trends in UKCS confidence and international markets has closed.**
>
> **Chamber viewpoint**

Figure 1 - Contractors: business confidence in UKCS

International

Since the November-April 2013 survey firms have consistently been more upbeat about their international activities compared to activities in the UKCS, however this is not as evident in the latest set of survey results as the trends have now almost converged. Once again we see positive trends for both actual optimism and for expected levels over the coming 12 months.

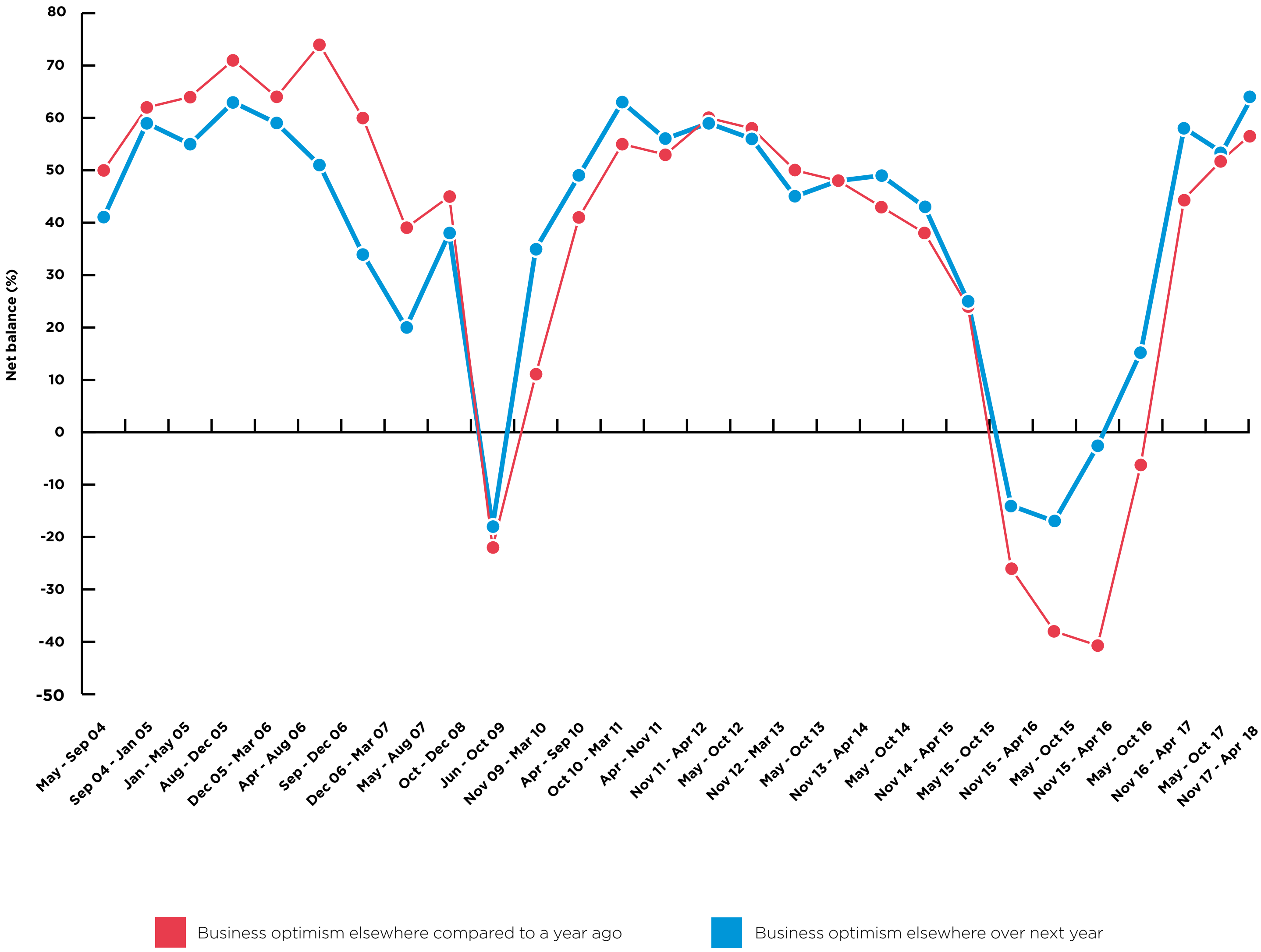
Between autumn 2015 and spring 2016 almost 50% of contractors recorded a decline in confidence regarding international work however in the latest two surveys this has fallen to below 10%. Over the past 12 months more than half of contractors reported being more confident about the international business situation.

Optimism in the international oil and gas sector increased for 61% contractors and 67% are forecasting a further rise in confidence over the next 12 months.

A net balance of plus 59% of contractors are more confident about their current international activities, up from plus 51% in the previous survey.

Licensees and operators also recorded an increase and expect a further rise in optimism about the oil and gas industry outside of the UKCS.

Figure 2: Contractors - business confidence in international markets



Trends in business activity

Trends in business activity

Moving from confidence to the specific activities of firms in this year and over future periods.

Firstly, firms were asked about the value of their organisations work in the UKCS in production-related work, decommissioning work and exploration activities (see **Figure 3**) and secondly were asked about the forecast trend in the value of work over the next 12 months (see **Figure 4**). Firms were also asked the same questions regarding their international activites.

In the previous survey there was a negative trend in the value of production-related work in the UKCS (a net balance of minus 4%) with more firms reporting a reduction in the value than reporting an increase. However in the previous survey a net balance of contracting firms expected an increase in the value of production–related work during the six months to April 2018, and this forecast was upheld with a net of plus 20% expressing a rise in the value of UKCS production-related work. This is the first time since autumn 2014 that this trend has been positive. During the coming year a net balance of plus 46% of contracting firms are forecasting a further increase in the value of production-related activities.

In relation to the value of production work elsewhere, more than a third of contractors (35%) reported a rise and only 8% recorded a reduction, and during the coming 12 month period four in 10 firms are expecting an increase with only one in 10 expecting the value to decline.

In line with forecasts from the previous survey, licensees and operators, on balance, recorded an increase in the value of their UKCS production-related work.

The upward trend in the value of UKCS decommissioning-related activities, although remaining positive, eased from a net of plus 19% in the previous survey to a net of 11% reporting a rise in this current survey. Almost a third of firms expect a further increase in the value of UKCS decommissioning work during the coming year. Similarly international decommissioning-related activities, on balance, remained positive though eased from the last survey from a balance of plus 6% to a balance of plus 3%. Almost a quarter of contractors expect a rise in international decommissioning activity during the coming year.

The trend in the value of UKCS exploration-related work amongst contractors has been negative since spring 2014 with the negative trend dipping to its lowest point in

Figure 3 - Contractors - trends in UKCS activity in the last 12 months

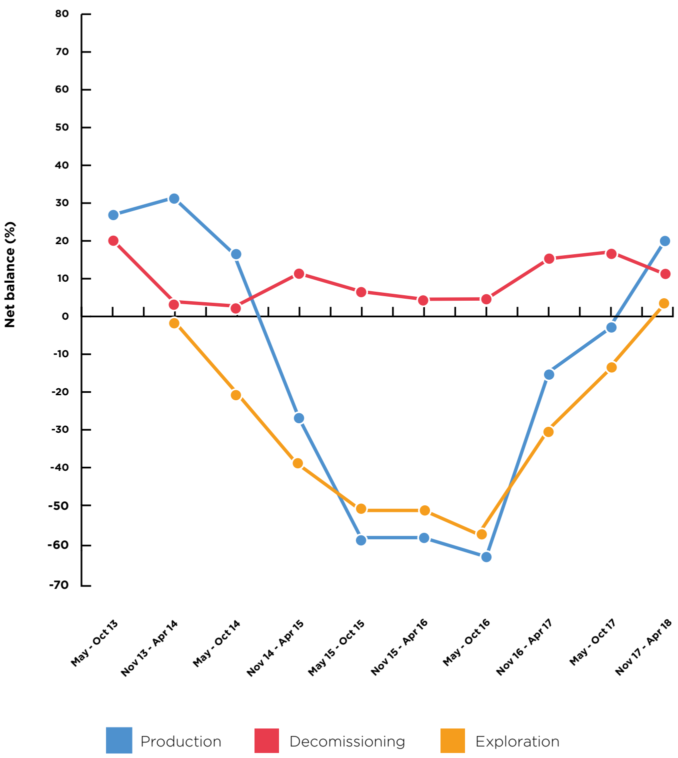
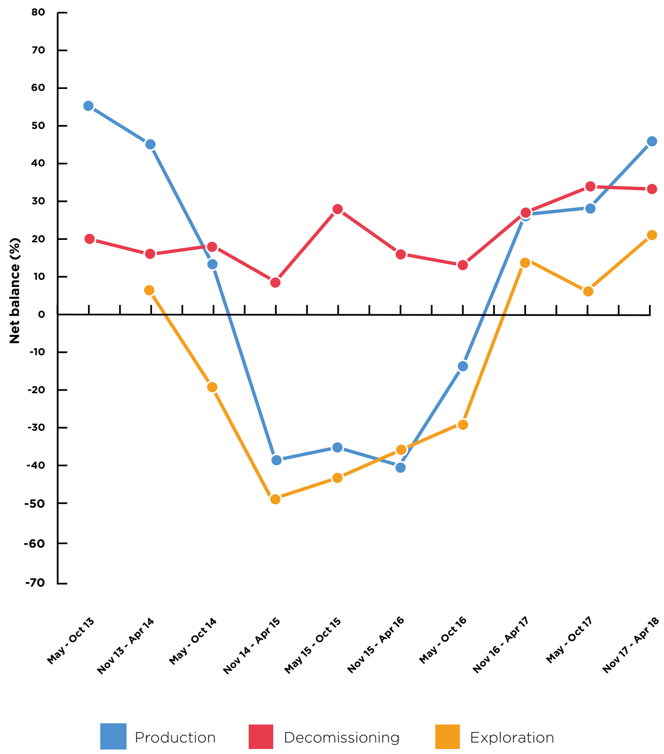


Figure 4 - Contractors – scheduled / expected trends in UKCS activity over the next 12 months



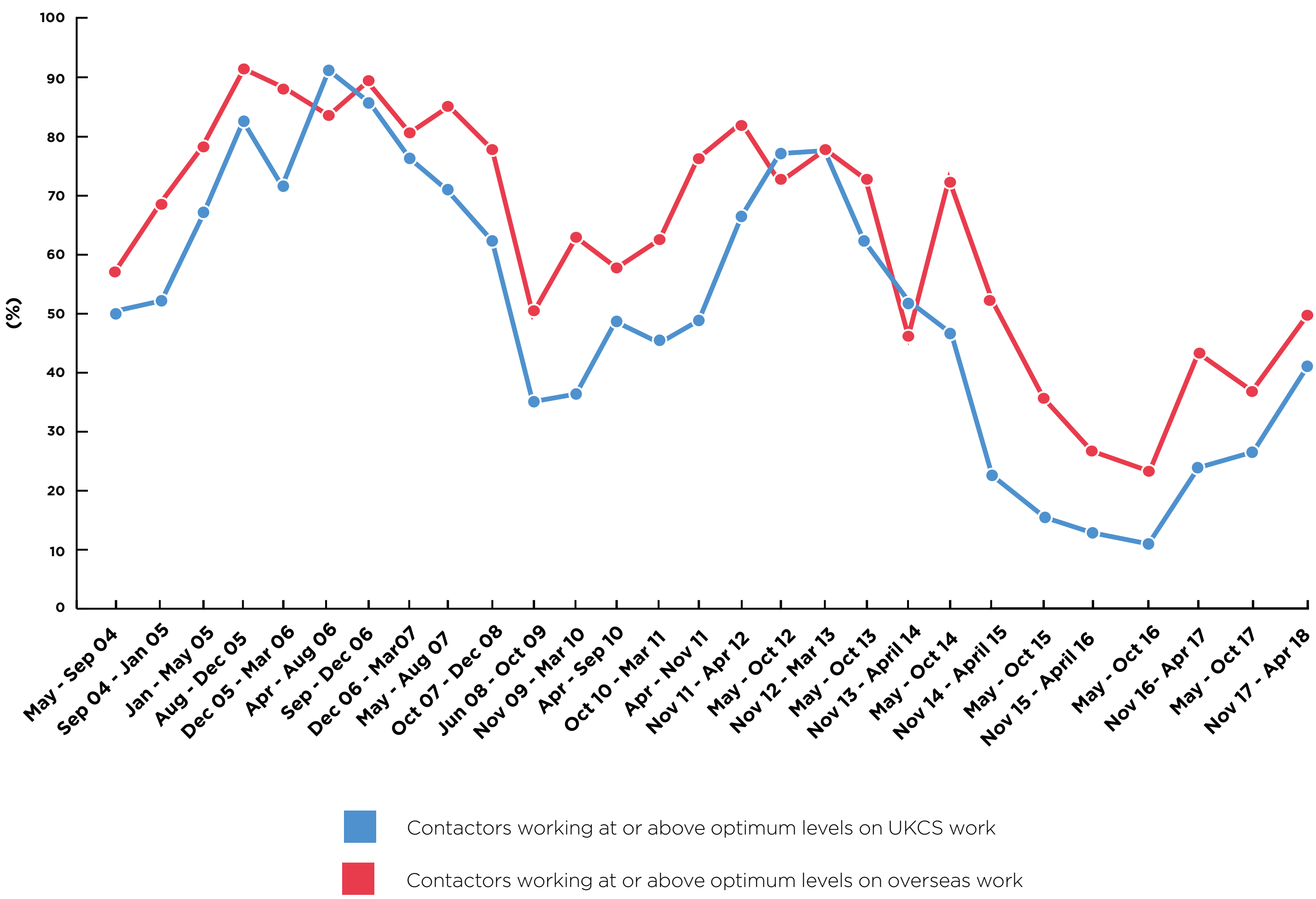
autumn 2016. Since then it's been steadily rising though remained negative until the current survey where the outturn was positive (a net balance of plus 3%). During the coming 12 months the trend is expected to rise further with a net balance of plus 21% forecasting an increase in the value of UKCS exploration activity. The value of international exploration work has, on balance, been negative since spring 2015 however in this latest survey a net balance of plus 4% of contracting firms indicated an increase and a net balance of plus 18% expect a further rise during the coming year.

On balance, licensees and operators from the previous survey reported a decline in the value of UKCS exploration work with little or no improvement expected. In this current survey more than half of licensees and operators reported a decline however a small net balance are now forecasting a rise during the coming twelve-month period. Excluding seasonal factors, the trends in total work elsewhere for licensees and operators remained flat however firms are anticipating an increase in overseas exploration work in the next 12 months.

Figure 5 illustrates the percentage of contractors working at or above optimum levels over the period since the survey started in 2004.

The share of contractors working at, or above, optimum levels in their UKCS operations peaked at 79% in the spring of 2013, it declined steadily over the three years until the autumn 2016 survey when it stood at 12% (the lowest figure since the survey began). During the last survey 27% of contracting firms reported working at, or above optimum levels in their UKCS operations and in this latest survey the trend improved again and now 41% (the highest figure since autumn 2014) of contractors are working at, or above optimum levels.

Figure 5: Percentage of contractors reporting working at or above optimum levels



Trends in business activity

Decommissioning activity

Figure 6 shows contractors' expectations of involvement in decommissioning activity over the medium term. In the previous survey, a total of 83% reported that they were "definitely" or "possibly" likely to be more involved in decommissioning. In this most recent survey, this has eased slightly to 78%. We find:

- 30% (37% in the previous survey) reported they would definitely be more involved in decommissioning.
- 48% (46% in the previous survey) reported they would possibly be more involved in decommissioning.

In Survey 24 (November-April 2016), we recorded the highest level of contractors reporting that they were definitely or possibly likely to become more involved in renewables (63%), this declined to 53% in Survey 25, was relatively unchanged at 54% in Surveys 26 and 27 and in this latest survey we also find little movement - 56% (see Figure 7).

As in the previous report our results for this latest survey find that once again 60% of contractors expect to be either definitely or possibly involved in UKCS unconventional oil and gas in the medium term. The percentage of firms stating that they would be unlikely to be, or definitively wouldn't move into unconventional areas in the UK was virtually unchanged, at 36%.

With respect to unconventional activities outside of the UK, 24% of contracting firms expect that their company will be more involved during the next three to five year period with a further 33% expecting a possible involvement. The proportion stating that they would be unlikely to, or definitively wouldn't move into unconventional areas in international markets was 36%. Fewer than 10% of licensees and operators (compared to 27% previously) expect to be involved in unconventional activities in the UK, however 46% are open to the possibility of becoming involved in activity outside of the UK.

Figure 6 - Contractors - Involvement in decommissioning activity in the next three to five years

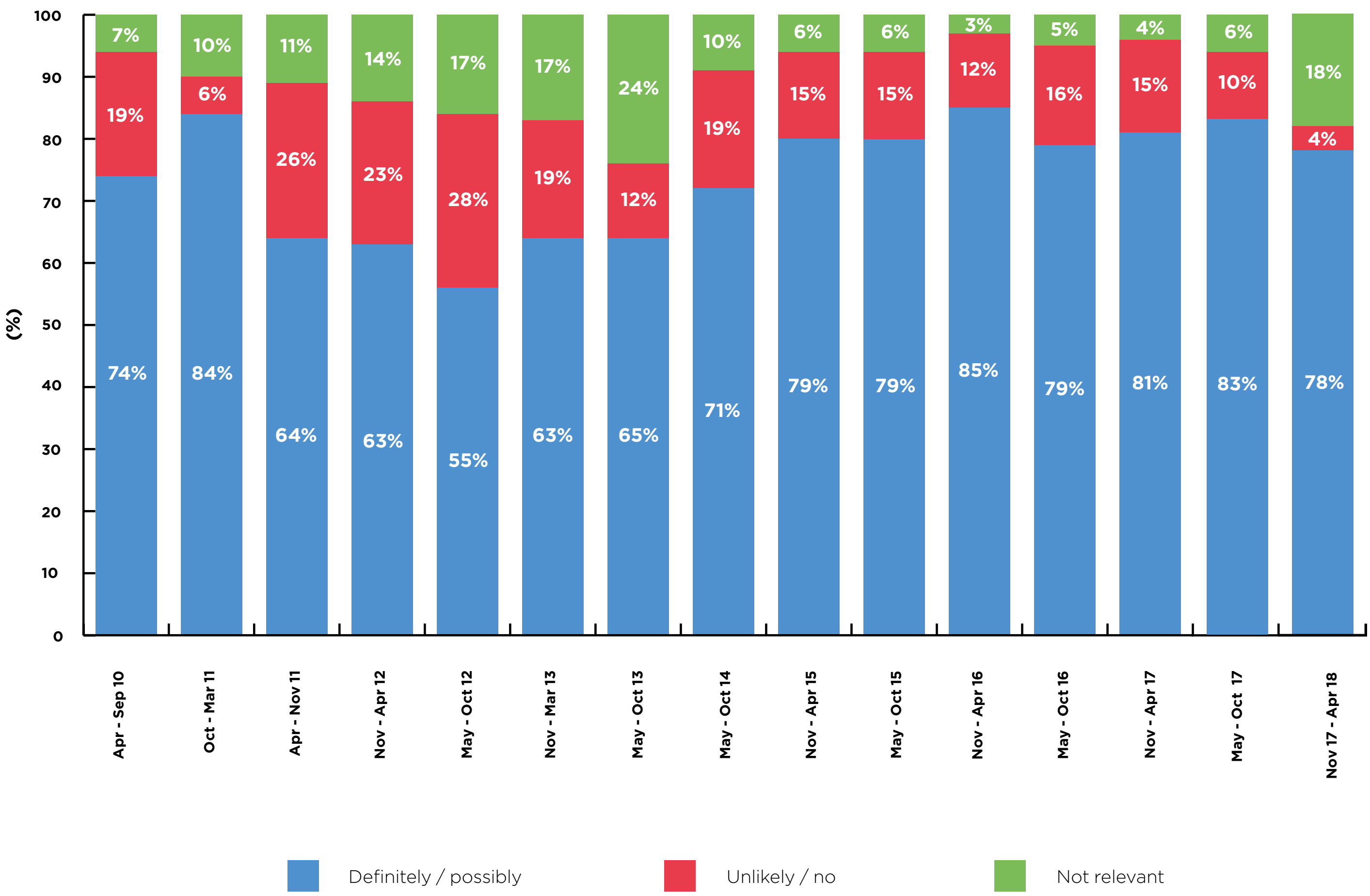


Figure 7 - Contractors - involvement in renewables in the next three to five years

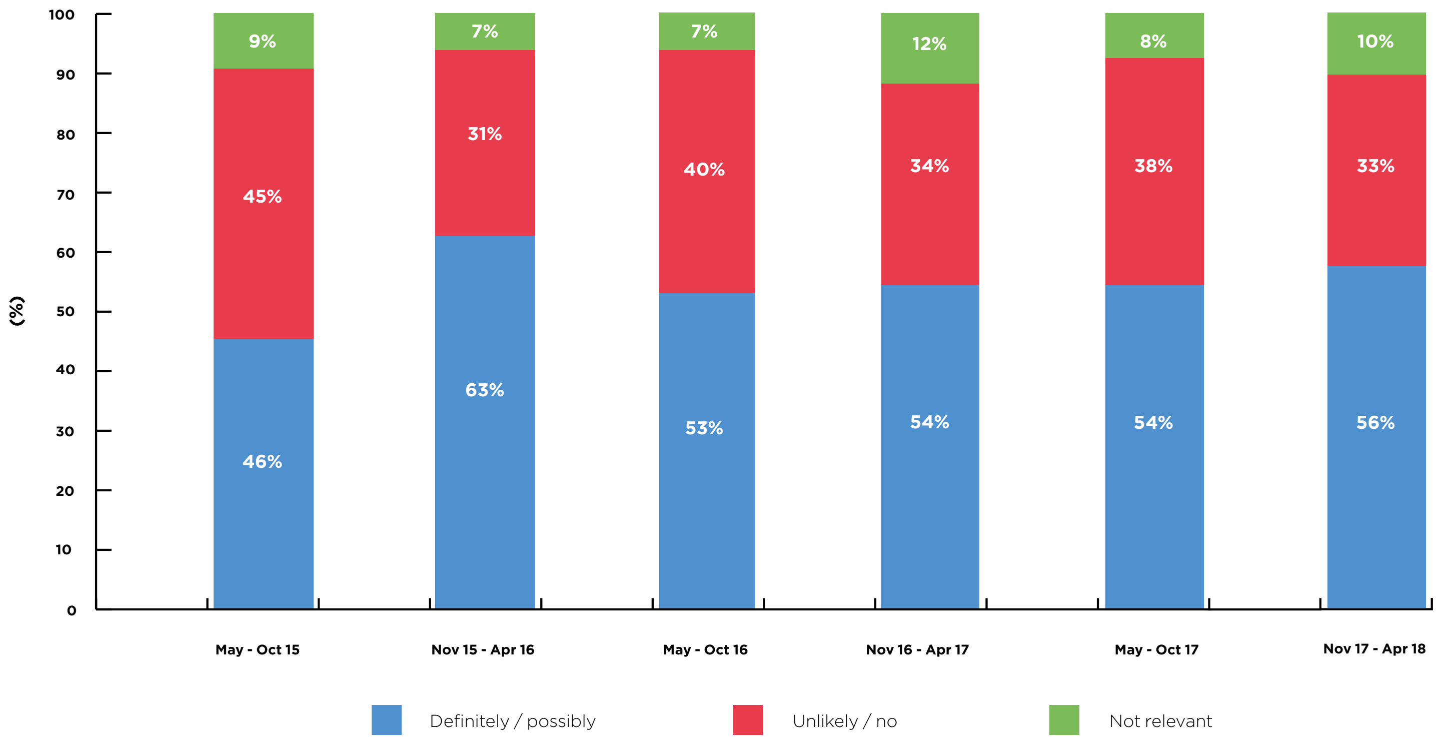
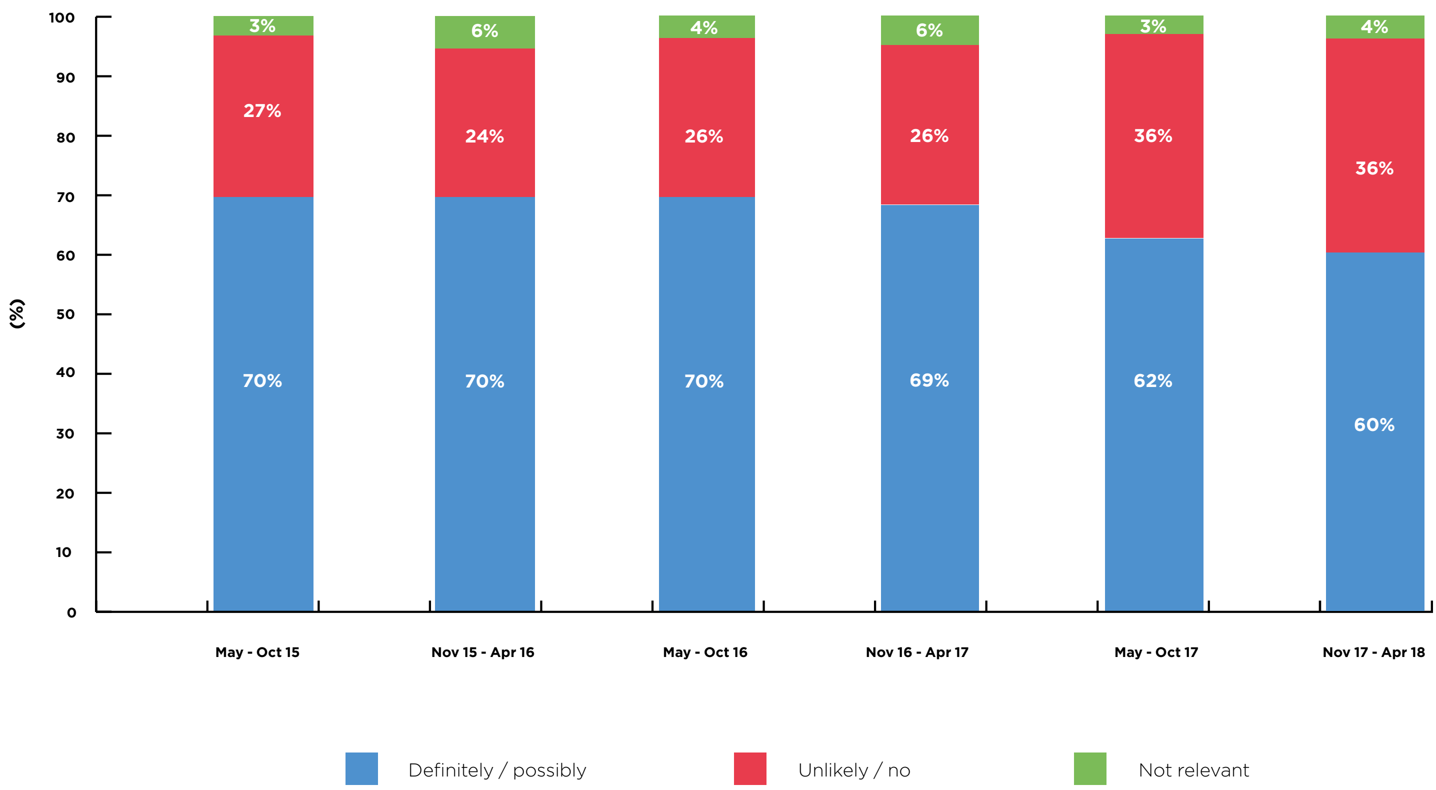


Figure 8 - Contractors - involvement in unconventional activity in the UK in the next three to five years



Trends in business activity

Employment changes

In its Economic Report 2017, Oil & Gas UK estimated that the number of jobs supported by the oil and gas industry declined from just over **315,000** in to 2016 to around **302,000** in 2017. The 2017 figure is made up of around **28,000** directly employed by oil and gas companies and major contractors, at least **141,000** in the wider supply chain and a further **132,000** induced jobs. This survey draws on responses for oil and gas operators and contractors who currently employ more than **33,000** employees.

We seek information on the current UK-based workforce for each firm, and this allows us to calculate an illustrative percentage change in total UK-based workforce for both periods.

Our findings from survey 27 showed that:

- In the 12 months to October 2017, operators reported a **6.2%** reduction in their UK-based headcount.
- For contractors, the 12 months to October 2016 saw a **1.3%** reported weighted average reduction in their UK-based headcount.

We repeated these questions in this survey and find:

- In the 12 months to March 2018 we calculate that operators and licensees reported an effective **5.4%** reduction in employment compared to a reduction of **6.2%** in the previous survey suggesting that the rate of job reduction has slowed marginally.
- In the next 12 months, operators anticipate that there will be a **4.2%** reduction in headcount– once again a slight easing of the downward trend.
- Contractors reported essentially a **0.2%** increase in headcount during the 12 months to March 2018 compared to a **1.3%** reduction during the 12 months to October 2017 implying that the recent trend in job reduction has halted.
- Over the coming 12 months contractors now anticipate increasing headcount by an average of **3.9%**.

The next survey (autumn 2018) will feature a section on recruitment, retention and skill shortages. It will be able to pinpoint early signs of any pending challenges firms may face recruiting employees with the appropriate skill sets.

Vacancies

In this latest survey we find that the vacancy rate (i.e. vacancies per 100 jobs) for operators/licensees decreased marginally during the last six months and stands at 0.63 compared to 1.4 in the previous survey. The vacancy rate for contractors rose from 2.7 in the previous survey to 5.89.

These remain low and suggest limited prospects for hiring in the sector, though the downward trend in operator/ licensees employment has eased and contractor headcount is forecast to rise in the next 12 months.

Case study - John Bell Pipeline

Tell us a little bit about your company, what you do and what makes you different.

John Bell Pipeline has been established in the North-east of Scotland since 1976. We also have a facility in the Central Belt of Scotland in Grangemouth. We are different in that in the field of piping equipment, we don't just focus specifically on pipe, fittings, flanges or valves. We provide and stock both groups of products, plus other associated products such as flange bolts and gaskets, structural products.

This enables us to support and provide a service to companies at all levels within the oil and gas supply chain. The depth and range of stockholding has allowed us to secure supply agreements with multiple clients whereby we supply them a whole basket of goods.

A key part of our structural offering is our Core-6 division, which is specialised in providing access and walkway solutions in GRP fibreglass materials. This has assisted us with penetrating a number of sectors, other than offshore oil and gas.

Some of the industries we have been involved are offshore wind, nuclear, energy from waste, power distribution, rail, marine, fuel distribution, defence and agriculture.

What has been the biggest challenge your company faced during the downturn and how did you overcome this? Has your company changed its approach as a result?

Like the vast majority of oil and gas service companies in the North-east of Scotland, the drop in spend throughout the supply chain had an impact on the company's revenues.

As with previous industry downturns, the decision was made by the company to sustain and continue to invest in stockholding; and to maintain the same level of headcount. This has proven to be the correct thing to do as with an upturn in business we have needed that resource to enable us to service our client base to the same levels, hopefully better, than during pre-downturn times.

All-in-all we recognised that the approach of maintaining good old-fashioned principles in being responsive to customer demands and customer care was and is still key. We have restructured our internal sales team in a way to provide more one-to-one care to individual clients.

We have also actively been looking at growing our international business and have had success, particularly in exporting to Africa. This going to be an area which will be focussed on heavily for the company. Becoming part of an international group of companies, Bianco Group, has helped with this venture.

Do you think there are skills gaps within the industry and where do you think they are most acute?

We have found that in certain technical fields, particularly those that are quite niche people with specialised valve knowledge, are quite challenging to find. Another area where there is a skills gap is managerial skills (specifically roles that involve managing people).

How has your company tackled these shortages to date?

We have used specialised recruitment companies to help find people. There has been a lot of emphasis on recruiting and developing people within the organisation and utilising 3rd party training.

What is your company's approach to recruiting graduates or young people?

Recruiting young people has always been a significant part of the company's recruitment strategy. A high percentage of the workforce has joined the company either from school or as young adults and have stayed with the company for a number of years. Young people have also been given the opportunity to advance into positions such as being a part of the sales and purchasing teams. The company was recognised for its commitment to recruiting and developing young people in 2016 in receiving Investors In Young People accreditation.

Does your company have any success stories of recruiting a graduate / school leaver?

A recent example took place in our Grangemouth office, where we employed a school leaver at the end of last year for the position of sales trainee, with a view to the future of the company. We contacted the four local high schools and asked them to put forward some candidates. A series of interviews were done and one outstanding candidate was identified (now since employed). As part of the process, we invited his parents to the company to explain what the role was and the prospects. This is a process that we would definitely look to repeat in the future.

What are your company's recruitment plans over the next year?

We are presently considering looking at securing additional resource on the sales / purchasing side of the company (taking into consideration our strategy on internationalisation).

Investment trends

Investment trends

In this survey we explore trends in investment in the last 12 months and scheduled investment plans over the next two years.

On measures of investment spend, the overall picture is significantly more positive than in previous years. For contractors, the net balance of total investment spend for the UKCS area in the last 12 months improved with more contractors increasing investment spend in the UKCS area (30%) than reducing spend (21%), while more than a third of contractors (35%) reported no change to their investment spend. This balance of plus 9% compares to a negative net balance of minus 22% one year ago and to a negative net balance of minus 32% two years ago.

The outlook for the next two years is even more positive. More contractors expect to increase investment (51%) than reduce (8%), while just over a quarter of contractors (26%) are forecasting no change to their investment spend. Operators and licensees, on balance, are also forecasting a rise.

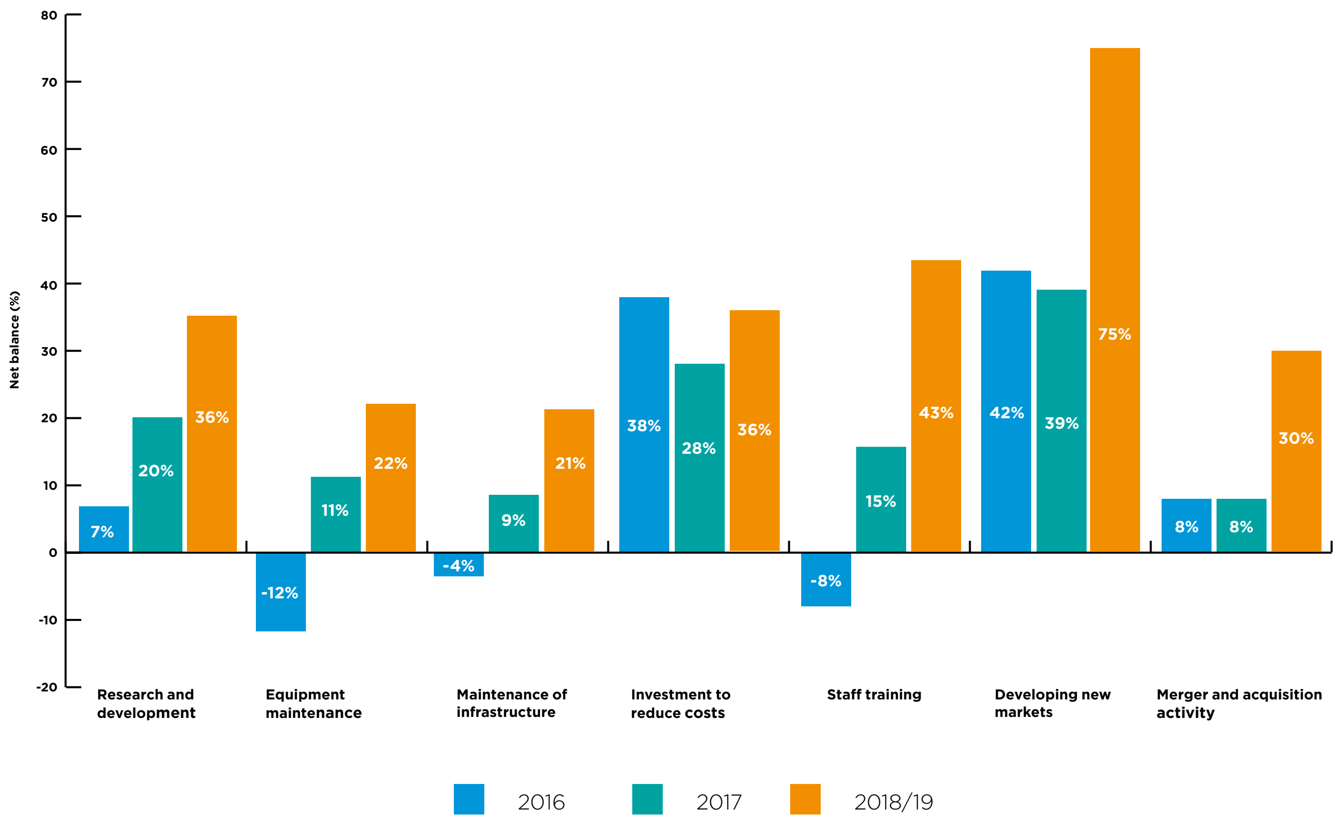
Figure 9 shows the net balance between those contractors reporting an upward and those reporting a downward trend in each category of investment spending (i.e. the share of contractors reporting an increase in spending in this category minus the share of contractors reporting a decrease in spending). This reveals that the net balances for investment activity was positive in all categories (i.e. more contractors reported increasing than reducing spending in each of the categories). In the previous survey staff training, equipment maintenance and maintenance of infrastructure had been negative.

In this latest survey improvements were recorded in staff development and in equipment maintenance, the maintenance of infrastructure and staff training categories. In the previous survey a net balance of minus 12% of contracting firms reported a reduction in the spend on equipment maintenance but in this latest survey a net balance of plus 11% reported a rise and a further net balance of plus 22% of firms expect a rise during the next two years. Likewise, maintenance infrastructure spend declined for a net of minus 4% in the previous survey but in this current survey a net of plus 9% reported an increase and a net of plus 21% expect a further increase during the next two years. Operators also reported, on balance, improved investment spend on both equipment and infrastructure maintenance and as with contractors both trends are expected to remain positive.

Contractors have also reported increasing investment spend with respect to staff training whereas in the survey a year ago staff training investment declined for a balance of minus 8% of firms. However, in this current survey almost a third of firms (30%) reported an increase in investment spend for staff training compared to only 15% reporting a reduction. Operators and licensees also reported and expect increased investment spend for training.

Other categories, namely investment to reduce costs, research and development, developing new markets and merger & acquisition activity all continued to report and expect positive trends in investment spending for both operators/licences and contractors.

Figure 9 - Contractors - direction of investment spend in 2016, 2017 and scheduled trend for 2018/19



Investment trends

With regards to specific R&D activities undertaken by all firms, developing new equipment (57%), services (34%), processes (32%) and software (37%) were once again the most commonly cited. A total of 14% and 13% of firms reported active involvement in decommissioning and renewables research respectively. Improving extraction processes and extraction yields were noted by 8% and 7%. Almost one in five firms reported no R & D activity. For almost 60% of firms R&D activity was mainly located in the UK, with 10% seeing activity in Europe, 6% in the USA and 3% elsewhere.

In this survey we included a question to ascertain the extent to which firms used UK/EU funding or associated tax incentives for their R&D activity. The results indicate that slightly more than a third of firms (35%) said that the availability of R&D funding or tax incentives had influenced their company's decision to invest in R&D in the UK.

We found that two in 10 firms (22%) have used funding from, for example Scottish Enterprise, Highland and Islands Enterprise or Innovate UK, for R&D/NPD projects and that three in 10 have made use of use of the UK's R&D Tax Incentives (such as R&D Tax Credits and Allowances). Fewer than half of firms (43%) indicated that they had not made use of any EU/UK funding or tax relief.

Firms were asked how the volume and type of their company's R&D activities have changed during the past 12 month period. Very few firms reported that their investment activities declined and only around one in six firms providing a response said that there had been no real increase in investment activity. Most firms indicated that investment activity has grown during the last year.

A number of firms specified that their investment focus has been moving from traditional oil and gas activities to other sectors. One firm noted that they were now 'more focused outwith the oil and gas sector in industrial services and the petrochemical industry' while another has moved its focus to an 'increase in polymer development and initiated R&D into mechanical equipment'. For others the focus was primarily on new technology and services with a typical response being 'more focus in new technology rather than developing existing technologies'. It is also evident that a proportion of firms are seizing opportunities arising from the decommissioning and renewables sectors with a number of firms reporting that they were extending their focus in these areas.

Figures 10 and **11** illustrate the changing priorities for contractors' investment spending between 2005 and this latest survey. These are reported again as the net balances between positive and negative trends in investment spending in each of six categories. Figure 10 shows the expected trends in investment spend between 2011/12 and 2018/19, while **Figure 11** shows the actual trends as reported by contractors' between 2005 and 2017.

The UK's R&D tax reliefs that are available to companies based here are a useful lever for the UK government to attract investment into the UK.

The longer-term future of R&D tax relief was confirmed recently within the Brexit Industrial Strategy, where the Government reiterated its commitment with increased benefits for large companies from 1 January 2018.

It is surprising to note that less than 3 in 10 of companies surveyed are taking advantage of R&D tax reliefs. Technological invention will continue to be key to the future success of the sector and we would expect the take up of R&D incentives by companies in the sector to increase as a result.

KPMG viewpoint

Figure 10 - Expected trends in investment spend by contractors (2011/12 to 2017/18)

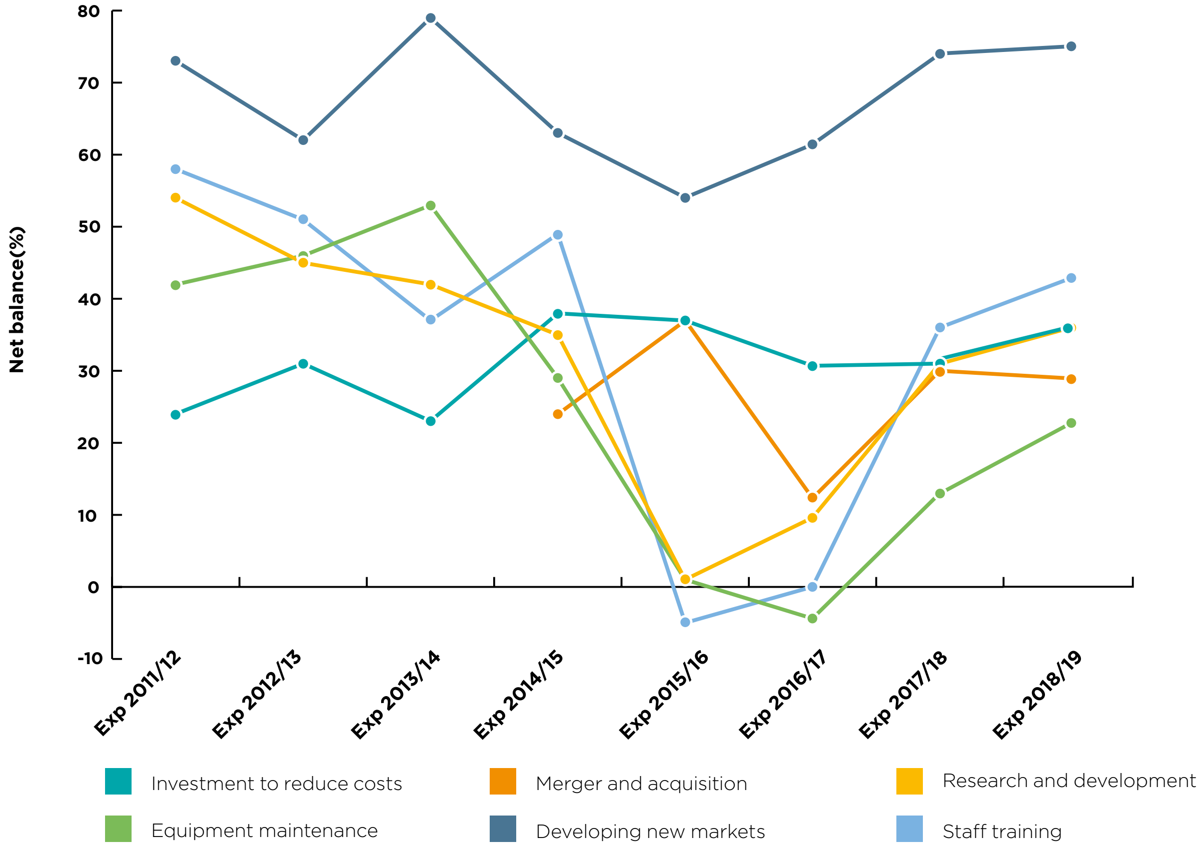
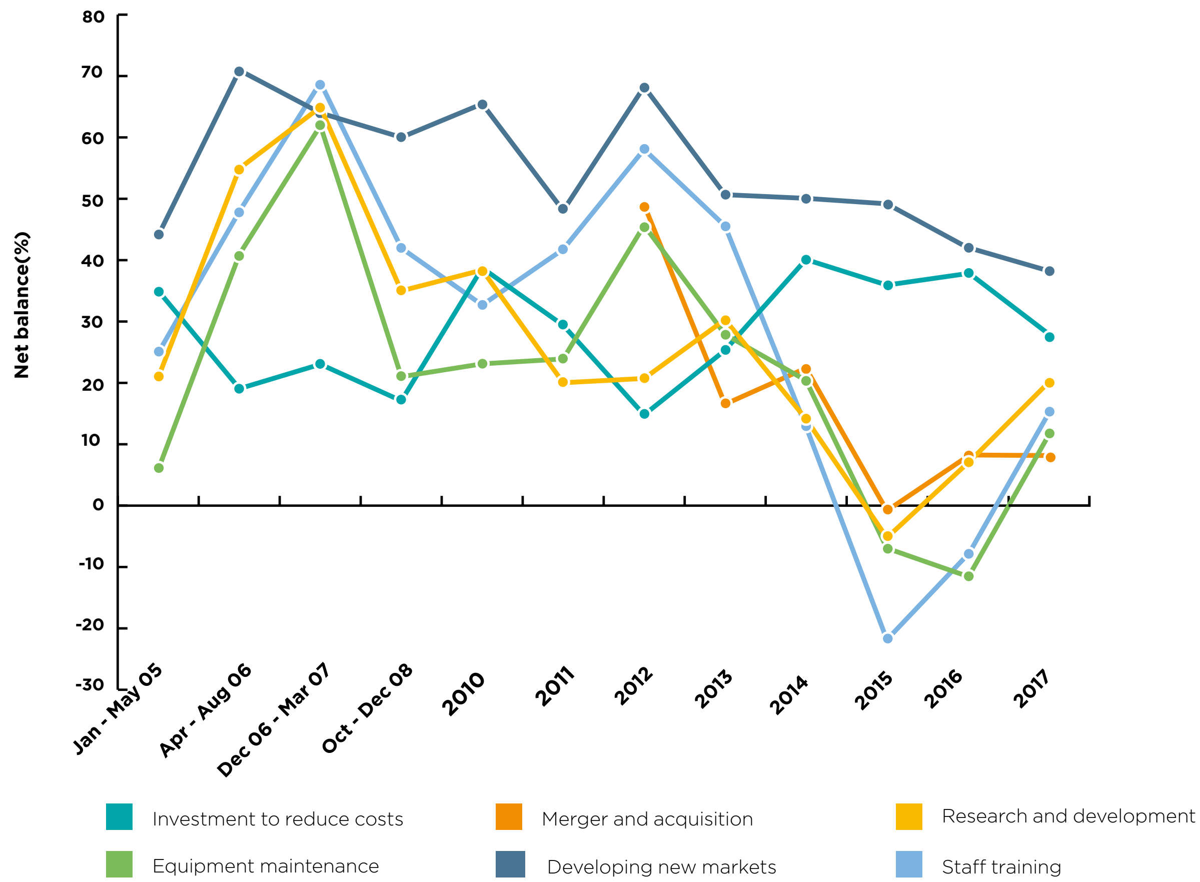


Figure 11 - Actual trends in investment by contractors, 2005 to 2017



Case study - Tendeka

TENDEKA

Tell us a little bit about your company, what you do and what makes you different.

Tendeka is an independent oil and gas service provider, specialising in advanced completions and production enhancement solutions. Our product portfolio includes sand and inflow control, zonal isolation, hydraulic fracturing, data visualisation and reservoir monitoring. We focus on modelling, monitoring and controlling flow from the reservoir to optimise our client's production. Technology and innovation are what makes us different: we aim to be the company people go to when they have a challenge with their wells. Also, we recently launched our fully wireless intelligent completion (PulseEight) which is very much in line with the key industry themes of 'the digital oilfield' and 'big data' and has the potential to be an industry game changer.

What has been the biggest challenge your company faced during the downturn and how did you overcome this? Has your company changed its approach as a result?

Obviously the last few years have been tough for everyone in the industry and particularly within the Aberdeen area which has such a large focus on oil and gas. For a relatively small organisation like Tendeka, the pricing reductions required by our clients have hit us hard, but we've managed to do this without significantly reducing head count. We have focussed on areas where we can still be profitable and worked on improving our supply chain by implementing a new ERP system. In 2017, we moved into our purpose-built headquarters in Westhill, Aberdeenshire, which means we are now all under one roof, making us much more efficient. Hopefully now things are starting to pick up again, I'm sure we are seeing the light at the end of the tunnel.

What will be your company's biggest investment focus over the next couple of years?

Our new CEO, Brad Baker, is proactive in driving a culture of innovation, not just on the technical side but also looking at new markets and new commercial models, to name a few. We are being challenged to think outside the box big time. So, investment focus is really on growing our business through diversification of technologies, clients and geographies. R&D will continue to be a large investment area for us as that is what we continually strive to do to stay ahead of our competition.

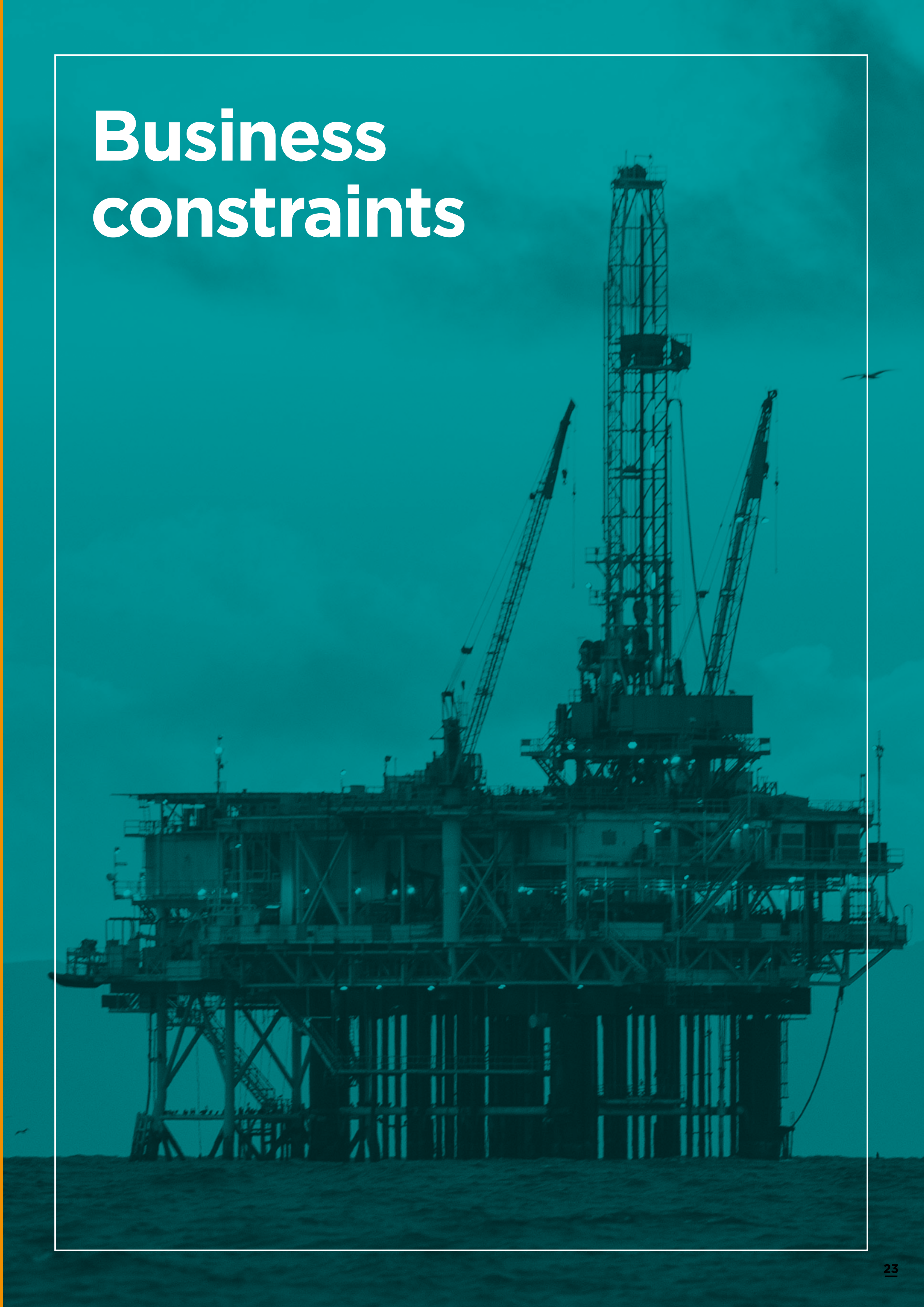
What role does R&D play in your company's investment strategy?

Research and development has always played a key role in Tendeka's investment strategy from our inception in 2009. Even during the downturn, we did not reduce our spend on R&D. Our recent launches of PulseEight and Cascade3, a solution for increasing longevity of water injection wells, are results of this. To be a technology innovator, we need to be continually developing our product lines to provide value for our clients. In addition, many of our technologies have been developed in conjunction with operators with specific challenges where investment has been shared and we have had access to trial wells. We have also worked with the Oil & Gas Technology Centre (OGTC) who have been supportive of our technology developments.

Can you tell us about any new developments or investments into new markets your company has undertaken recently?

In addition to our recent product launches, we continue to increase our market share and have actively entered new geographical areas. In 2017, we were awarded three large new contracts in the Middle East with ADCO, PDO and KOC and are in the process of delivering our first sand and inflow control systems for Chad and Venezuela.

Business constraints



Competitiveness and business constraints

This section explores the specific factors influencing UKCS activity and the actions firms are taking in order to retain a competitive advantage in the UKCS.

Since 2005, we have asked respondents to our spring surveys to indicate (from a list) which factors they thought were most likely to limit their activity over the coming year in the UKCS and elsewhere. The list of factors has evolved slightly over time. The changing patterns of factors identified by contractors to be important for limiting their activity in the UKCS since 2005 are given in Figures 12 to 15.

Figure 12 shows that the level of demand remains a very important concern for the overwhelming majority of contractors (74%). As for commodity prices, on the other hand, while remaining a notable limiting factor, the extent to which firms cite it as a very important factor, likely to constrain their activities, has lessened somewhat falling from 75% to 54%.

> **Although oil prices are lower than observed a few years ago, it is interesting to see level of concern regarding oil price has returned to levels recorded in 2013.**
>
> **Chamber viewpoint**

Figure 12 - The percentage of contractors reporting specific demand and economic factors as limiting UKCS activity

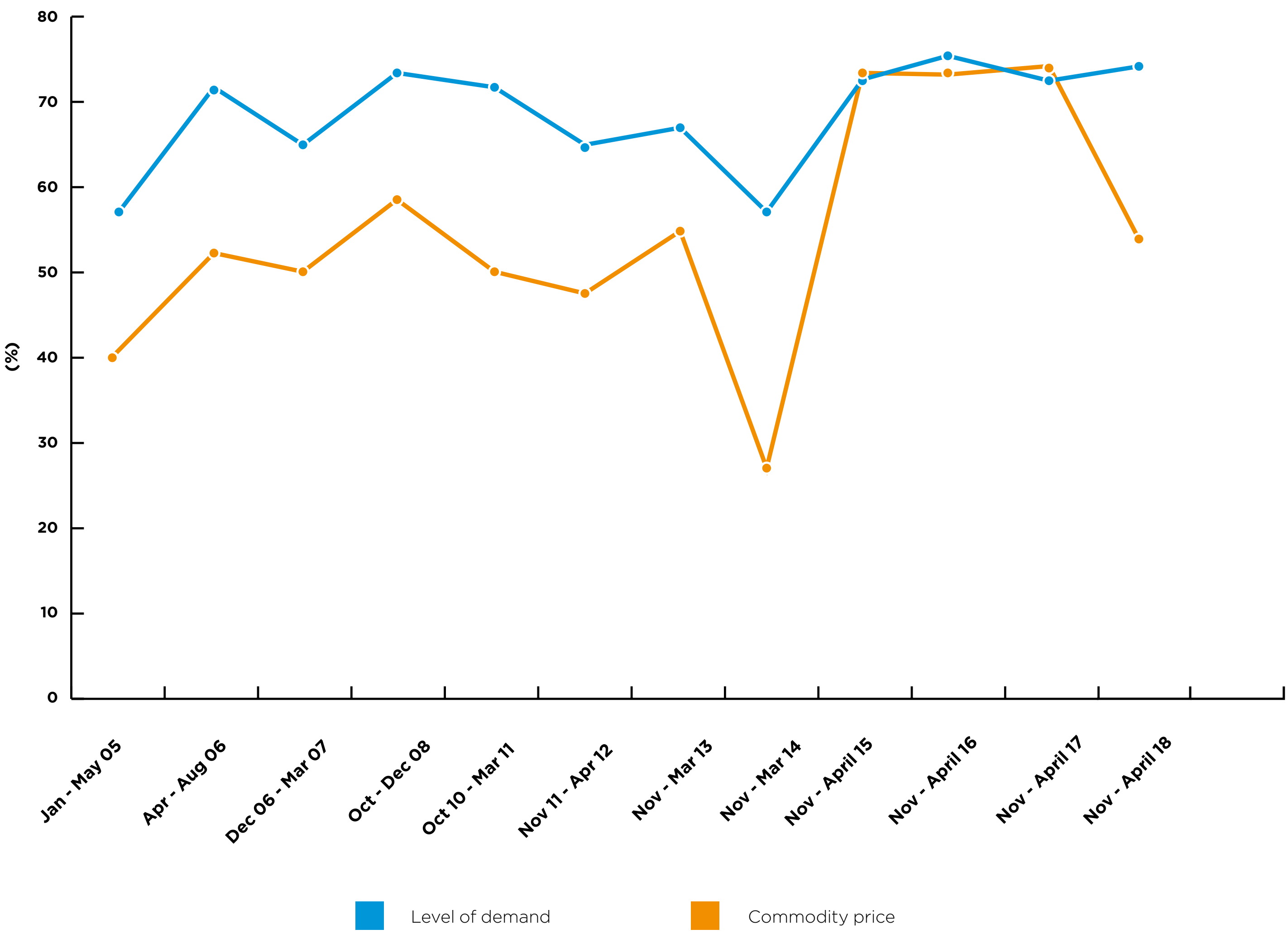
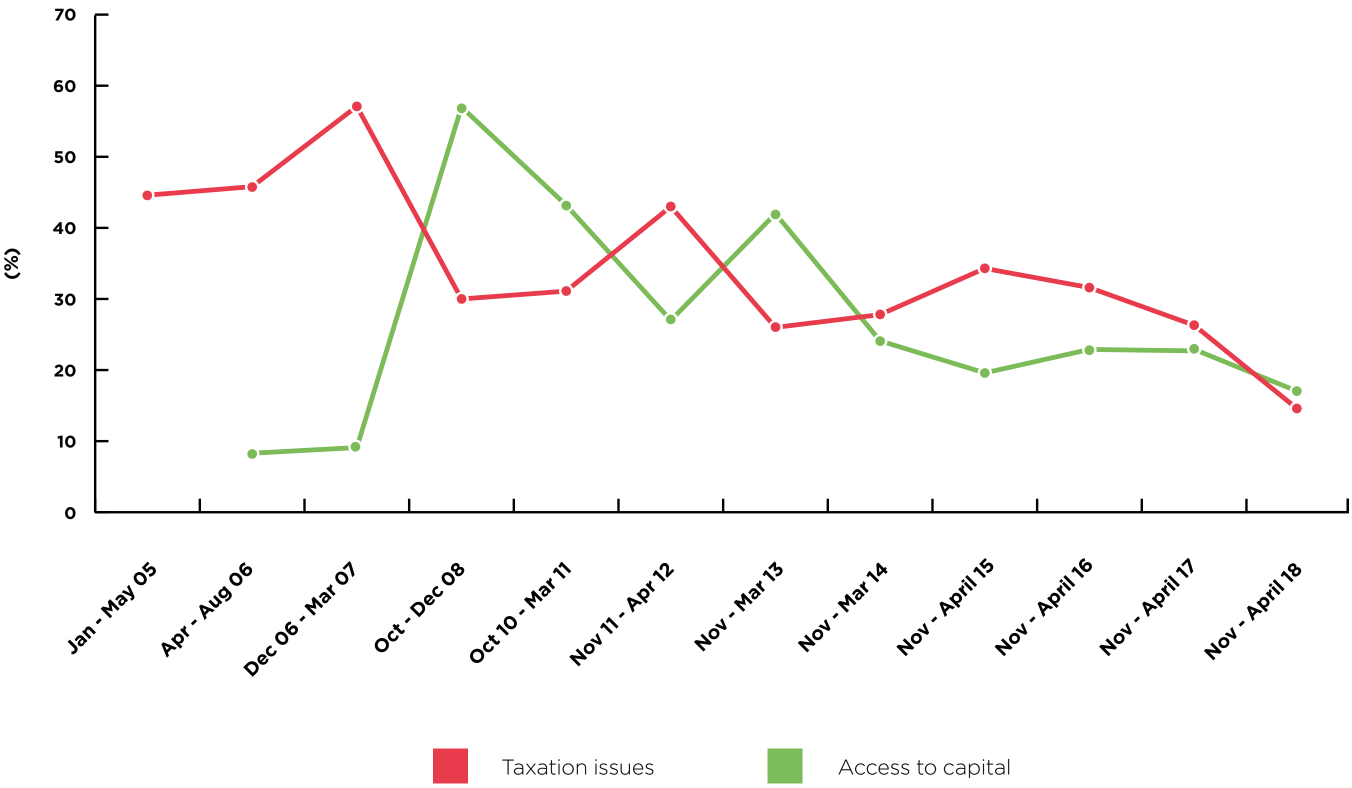


Figure 13 shows that the importance attached to taxation issues in limiting contractors' UKCS activity has eased from 26% of contractors citing it as a very important factor in last year's survey to 16% in this current survey. Similarly concerns around access to capital have also eased and are now a very important concern for just 18% of contractors compared to 23% in last year's survey.

Figure 13 – The percentage of contractors reporting specific cost and taxation factors as limiting UKCS activity



Competitiveness and business constraints

Figure 14 shows the extent to which skills remain and indeed are increasing as a constraint on firms' activities. In this latest survey 46% of firms reported it as a very important factor compared to only 26% in last year's survey. In recent years, alongside the fall in headcount reported by some firms, we found that skill shortages had eased as a constraint on firms' activities however it has increased over the two latest surveys and could be an important issue for firms seeking to expand in the future.

Figure 14 - The percentage of contractors reporting specific employment factors as limiting UKCS activity

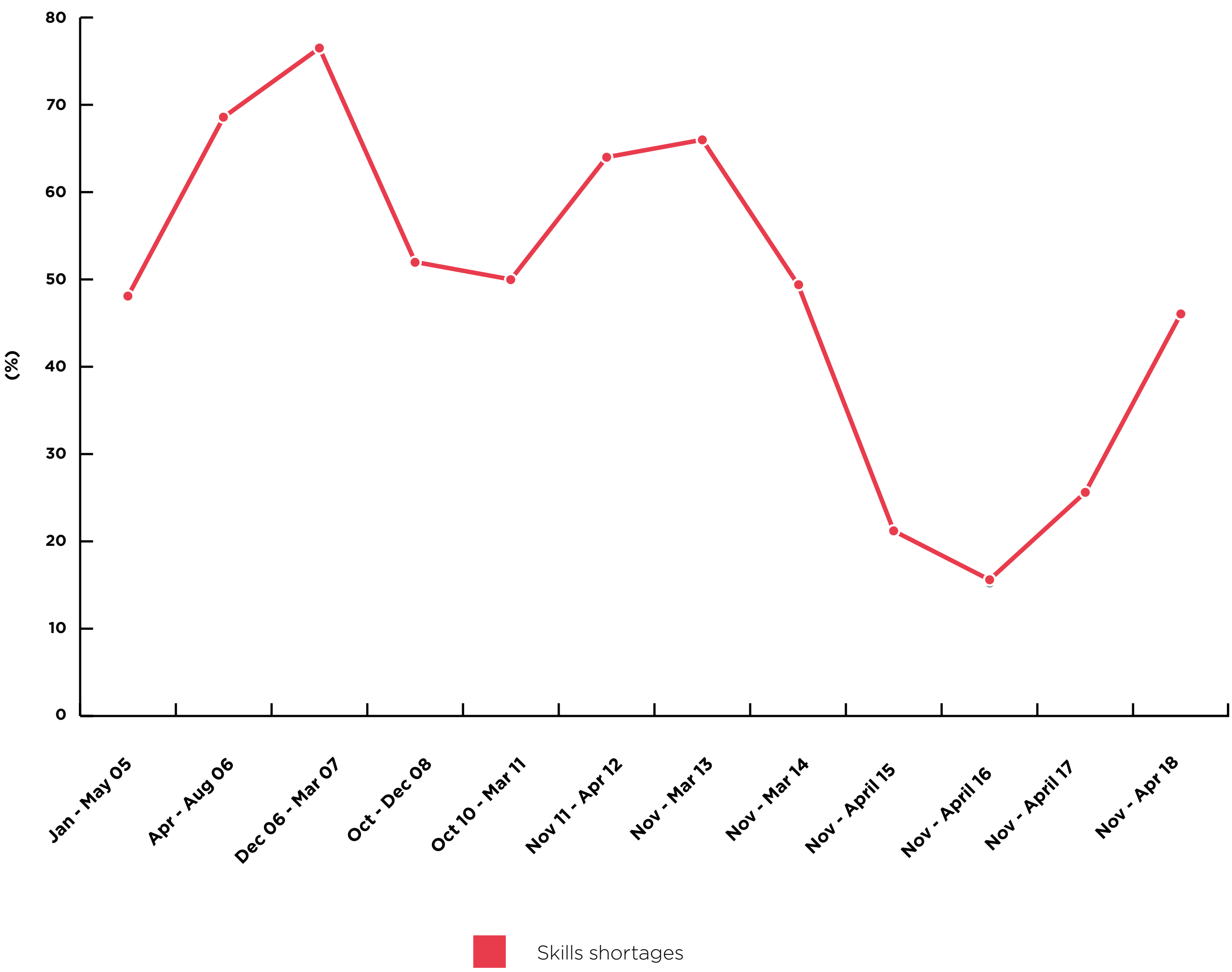
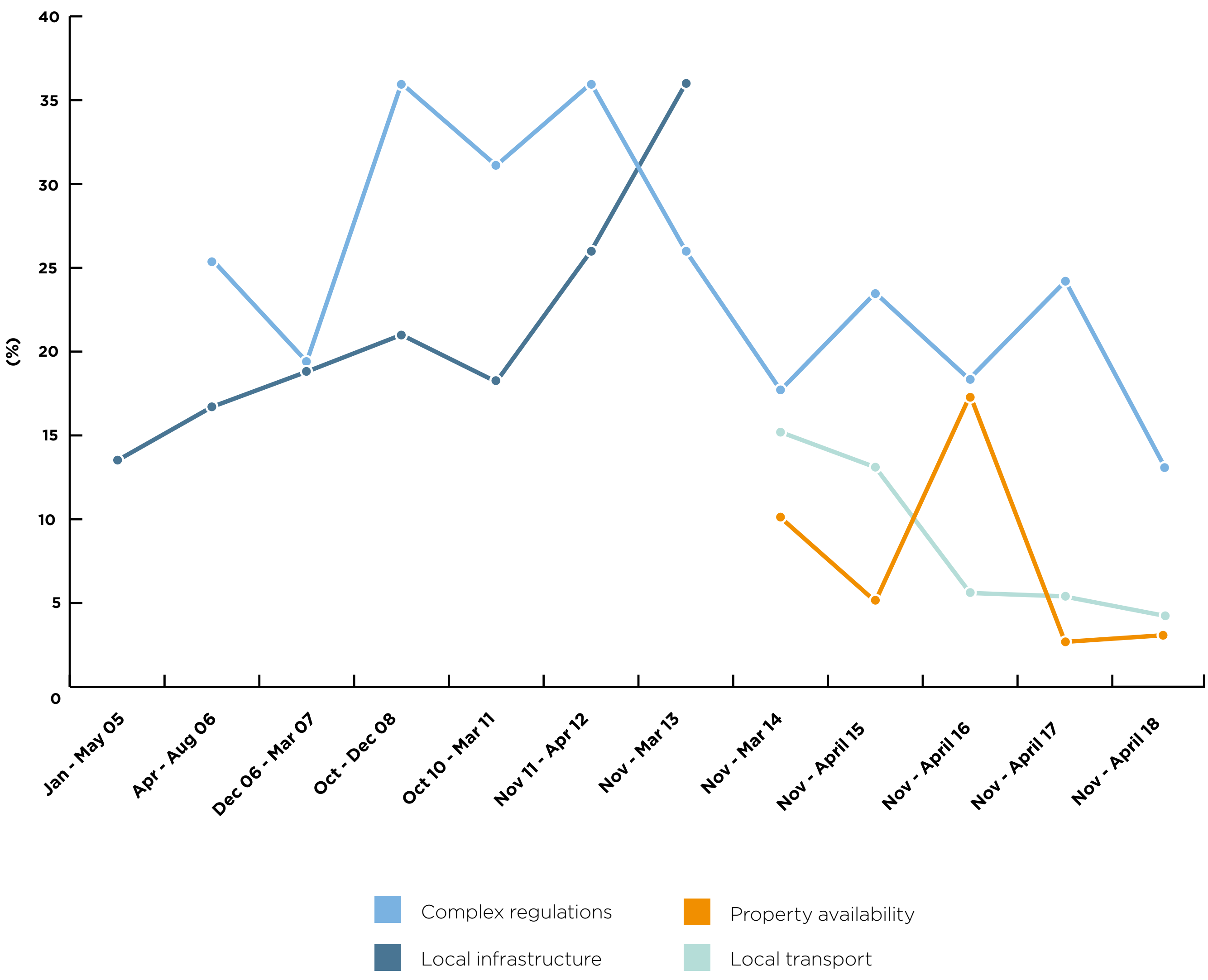


Figure 15 shows the changing views of contractors on regulatory and infrastructure issues. Complex regulations continue to be a major concern for contractors with 13% reporting these as a very important business constraint compared to 24% in the previous survey. Local transport issues were cited by fewer than 5% of contractors, therefore continuing to be of lesser importance as a business constraint. Slightly less than a fifth of contractors identified aging assets as an important factor in limiting activity over the coming year.

Figure 15 - The percentage of contractors reporting specific infrastructural and regulatory factors as limiting UKCS activity



We wanted to find out about the level of awareness of the Oil & Gas UK Supply Chain Code of Practice (SCCoP). We determined that slightly more than 70% of firms indicated that they were aware of the SCCoP with little distinction evident between contractors and operators/licensees.

In this latest survey we included a question asking firms to what extent they felt that the industry consistently adheres to the 30-day payment terms outlined in the Oil & Gas UK Supply Chain Code of Practice. A fifth of firms reported that they were always (2%) or often (18%) paid within 30 days. Marginally fewer than a third (30%) indicated that they were 'sometimes' paid within the 30 days outlined in the code of practice, however more than 40% responded negatively stating that they were rarely (30%) or never (12%) paid within 30 days. Slightly fewer than 9% were unsure.

The survey tells us that lengthy payment terms continue to be a problem for SMEs, creating liquidity issues. Against a backdrop of the UK's Payment Practices and Performance Reporting ('PPPR') regulations and Oil & Gas UK's Supply Chain Code of Practice, we need to see a significant shift in culture towards paying to faster terms if the sector as a whole is to flourish.

KPMG viewpoint

Figure 16 - Firms' view on industry adherence to 30-day payment terms

Percentages may not add up to 100% due to rounding

Current industry challenges

Current industry challenges

The future strength of the sector depends on operators, contractors and suppliers co-operating effectively. Behavioural changes in the industry are a key step in helping future-proof the oil and gas sector. These changes in the behaviour and culture of the industry are crucial for the sector's future vitality.

Firms were asked for details on the best examples they have seen of behaviour change in practice within the industry. Some positive behavioural changes around collaboration and co-operation were identified with examples including:

- Operators willing to engage with SMEs.
- Co-operation in logistics to reduce costs and improve safety.
- ETAP and Clair area planning with JV partners.
- In terms of innovation there is far more conversation with clients but not necessarily action.

Other respondents noted changes in behaviour with respect to new technology implementation and to other ways of improving efficiency:

- Being willing to try a new technology.
- Reduction in the number of consultants.
- More value put into good service rather than cheapest service for sustainability.
- More cost focused at every discipline level within the organisation.
- Across the industry companies are doing more with less, taking a lean approach to staffing levels. There remains, however, an underlying reluctance to move from historical suppliers as the effort involved is seen as too great.

A number of firms also identified negative behaviour changes, with many of the comments directed at operators and an emphasis on cost pressures.

- Delaying payment from operators to their service provider.
- There has been a shocking hammering of supply chain. Operators are battering contractors.
- Applying of contractual pressure on contractors to reduce cost. Now implemented across all operators, however not sustainable.
- The behaviours within the industry are still in transition. There are aspects where operators are still using the supply chain to derive the best solutions, however this is still not always fair and equitable.
- The operators have benefited from price squeeze on the suppliers - destroying the service provider to provide and maintain exceptional services. Many companies will not survive.

Firms have also highlighted damaging behaviour by firms in relation to contracts and invoices:

- Large organisations are expecting small companies to do more and more admin duties.
- Industry is run by contracts departments these days who have a disconnect from the real world of project delivery, potentially creating an unsustainable environment for service companies and in turn increasing risk exposure through a decrease in skills and competency.
- Pushing credit terms.
- Invoices suffering petty queries to delay payments.

We asked firms if their company was forecasting an increase in profit in 2018 compared to 2017. A total of 70% of all firms indicated that they expect profits to be higher in 2018 with minimal differences evident between operators and contractors.

"

The industry needs to find a way of contracting fairly and embedding gains that come from that will depend on deeper collaboration between operators and service companies. This demands a fundamental shift in attitudes, with both parties being open to sharing the mutual benefits of success that comes with collaborating on identifying and driving efficiencies.

KPMG viewpoint

Appendix

The Oil and Gas Survey is conducted by the Aberdeen and Grampian Chamber of Commerce and the results analysed by Strathclyde University's Fraser of Allander Institute.

Methodology

The Aberdeen & Grampian Chamber of Commerce Oil and Gas Survey seeks evidence of changing trends, and uses net balances as the principal survey statistic. Most questions of this nature ask the respondent to indicate whether the trend over the past four months and expected trend over the next 12 months is either 'up', 'level' or 'down'. The net balance for such survey questions is defined as the number of 'up' responses minus the number of 'down' responses to each survey question. Hence a positive net balance indicates a rising trend, and a negative net balance a declining trend.

Generally the net balance can be expected to reflect the direction of change of the variable it purports to measure. Thus, for example, a positive net balance with respect to orders indicates that orders are rising. So typically the balance statistics are assessed by comparing them with growth rates, not levels of official data series [Treasury Bulletin Vol. 4 no. 2 Summer 1993]. 91 companies responded to the survey, representing a response rate of 10% of companies contacted.

We would like to thank all survey participants. Without your time and input, we could not have delivered this research. Your continued support is invaluable to us in meeting our commitment to bring you independent and impartial insights into the key issues facing your business and the wider sector.

Contacts

Prof. Graeme Roy
Director

The Fraser of Allander Institute
University of Strathclyde

T 0141 548 3582
E graeme.roy@strath.ac.uk

Moray Barber
Partner

KPMG

T 01224 416976
E moray.barber@kpmg.co.uk

About the Aberdeen & Grampian Chamber of Commerce team

Have you got a business question? Well the team at the Chamber can help you answer it. Here at the Chamber of Commerce, our research team can support your business in a number of ways. We offer a bespoke approach which can be tailored to your individual organisation and objectives. We are currently delivering work for a number of members and over the last three years have completed over 100 commissions. We are here to help you and would be delighted to see if we can help solve your business challenges.

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The Hub
Exploration Drive
Aberdeen Energy Park
Bridge of Don
Aberdeen
AB23 8GX

–

T 01224 343900
E info@agcc.co.uk
www.agcc.co.uk