The Deconstruction Of The Seismic Industry

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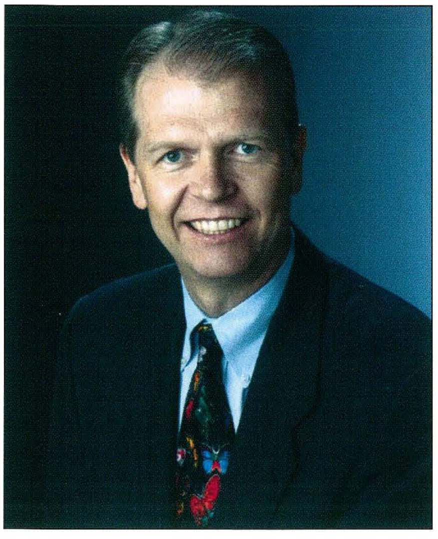

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World markets have recently punished many sectors for creating over-capacity, taking on too much debt, and running businesses without sound economic fundamentals. It reminds me of the old adages – forgotten in the 90s – "Profits are opinions; cash is king" and "Be careful what you measure because that's what you will get."

The media has been replete with examples of wild growth followed by implosion; first in the internet sector, then the energy-trading sector and more recently, in the telecom industry. The seismic industry is, of course, no exception and within the oil and gas service sector represents perhaps the best example of this appalling phenomenon.

A number of recent articles about this seismic boom/bust have included statements from Chip Gill, the President of the International Association of Geophysical Contractors (IAGC.) Gill, of course, did not pull his statistics from thin air, but got them from the core membership of the IAGC, which comprises the major geophysical service companies. Collectively, these statements represent the first public acknowledgement of the industry's failures to generate cash and make a sustainable decent return.

Gill brought two salient facts to light: 1) the cash flow of the seismic industry was negative throughout the 90s, including during a period of big uptake in 3D and the capacity expansion frenzy that ensued in response to the perceived need; and 2) a trend developed to balance sheet the cost of seismic surveys to be sold to multiple customers. The combination of a Wall Street-driven demand for growth, the resulting capital available to those who showed a growth story, and the ease of generating paper profits from balance sheeted survey costs, led to the inevitable result: a crash of seismic proportions.

This crash began in 1999, but has yet to work its way through the system completely, as investors, management, customers, and employees often remain in denial. Wall Street wanted growth in earnings and revenue, and got them in exchange for capital, which fueled the expansion. And while the players were rational in their own decision making, the outcome was a classic case of Prisoner's Dilemma, resulting in substantial industry overcapacity, as Bill French said recently*.

There is one other factor at play in both the buildup and the ongoing deconstruction of

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the seismic industry. This factor is the massive shift of risk from operators, whether they are major resource holders, supermajors, majors or independents, to the seismic service companies. This shift began in the late 70s – early 80s as the traditional time-based service contracts gave way to turnkey contracting. But starting in the mid-80s, the turnkey contracts, which were written by service companies, gave way to contracts driven by the operators; and if a knowledgeable executive from 30 years ago were to land in a contract discussion today and read one of these documents, I am sure he would say: "You must be out of your mind! We can't sign that!" Essentially, the third-party market returns deteriorated quickly from low double digits, to single, to zero, or less! – and then only if everything came out perfectly.

Murphy continually hovers over the seismic business because we keep him so busy writing new clauses to his long-standing laws. So, essentially the state of affairs today is one of Gambler's Ruin. The only way to win a competitive turnkey tender is to either put on the rose-colored glasses, gulp hard, and take more risk than one should - or worse, agree to the excess risk out of ignorance, incompetence, or desperation. Anybody hear of the "must-win job"? This is another way of saying "big loss coming".

One of the newer tricks of the trade is to convert a proprietary job over held acreage into a "highly prefunded multiclient survey". What this means is the balance sheet will take the cost, sometimes including interest and R&D charges, and the revenues from the operator will be booked as a multiclient sale with usually 25-40% taken as profit, as "we expect to make additional sales".

Tactics like these amount to a very unsophisticated Ponzi scheme that, amazingly, continues to dupe Wall Street. The thinking goes "If we shoot more spec each year than the year before, we can show earnings growth and who cares if it is financed by negative cash flow." These tricks, or just plain old shooting in the wrong zip code with the wrong technology, result in write-downs of the balance sheet, and these have been on the increase, believe me.

So how do we get out of this state of affairs? The investors, management, and employees of the seismic service companies must, of course, take the lead. The market will eliminate some of the weaker players. This has already begun. Far better internal discipline and financial controls are needed, as well as perhaps an industry-wide forum on proper accounting practices overseen by GAAP.

But one other fundamental change is needed if the E&P operators are to have a seismic industry around to serve them: A general all-round change in attitudes - within the service companies, the investors, and the client community. Seismic service companies must practice, and demand, rigorous investment discipline; i.e., ensure a return. Investors need to hold the industry accountable to economic fundamentals. And the oil and gas companies need to actively engage with the IAGC and its individual members to improve contractual terms and restore the risk/reward balance.

If not, then stand by while the industry is fully deconstructed and – we are not crying 'wolf' here – there will be a high price to pay, both in the loss of experience and capability today, and in the rebuilding required tomorrow.

**From "The Oil Company – Geophysical Contractor Relationship", PESA News, February/March 2002*

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