Deepwater revival: Deepwater drilling, roundly lauded as the industry's Brave New World, has sloughed off of late. Main problems have been a lack of continuity in programs, the lingering aftershocks of the low oil prices and a rash of dry holes. Analysts expect improvement late this year and in 2001. Photo of the deepwater drillship Ocean Clipper courtesy of Diamond Offshore Drilling.

Gulf of Mexico: Operators still skeptical of oil-price prospects

by Jerry Greenberg, Contributing Editor

IN THE MID-1980S, a small independent oil company called **ZIM Energy** was handing out bumper stickers exhorting people to "Think $28/Barrel". Well, oil prices were hovering around $30/bbl for a time this spring, and above $20 for the past 6-8 months. At those prices, Gulf of Mexico drilling contractors and other service companies could reasonably expect to see exploration activity shoot through the roof, right? After all, it wasn't too long ago that oil prices were near $10 per barrel.

Unfortunately, despite high oil prices, Gulf of Mexico drilling activity has languished since the beginning of the year. However, most industry executives and Wall Street analysts are predicting (hoping) for a significant upturn in activity in the second half.

The question is, with commodity prices so high, why haven't operators begun drilling in earnest?

GULF MARKET IMPROVES

It hasn't been doom and gloom all the time. The Gulf of Mexico rig market increased significantly since spring 1999 when 112 offshore rigs were under contract, representing a 62.5% utilization rate. Utilization stood at 77% at the beginning of this year with 141 jackups, semisubmersibles and drillships contracted.

Most of the increase occurred during the fourth quarter. Since the beginning of 2000, the Gulf of Mexico rig count has increased by only four units, according to **Tom Marsh**, drilling analyst with **Offshore Data Services** in Houston. But at the same time, Mr Marsh says, dayrates are continuing to increase as older contracts expire and new contracts are signed at higher rates.

Jackup rigs are faring better than floaters, according to ODS figures. The jackup utilization rate stood at 82% last March with 119 units contracted out of 144. Floating drilling rig utilization was 58% with only 22 of 38 units contracted. Most of the jackups are being contracted by independent oil and gas companies such as **Coastal Oil & Gas**, **Spinnaker Exploration**, **Samedan**, **Apache** or **Newfield Exploration**. Majors such as **Chevron** and **Exxon/Mobil** are also active on the Shelf.

Activity among floating rigs in the US Gulf is mixed. Deepwater drillships, several of which were built specifically against long-term contracts, are faring quite well with all under long-term contracts.

Semisubmersibles are another story, however. Several shallower-water semisubmersibles, those rated for water depths of between 800-2,200 ft, are idle or cold stacked. Most of the deeper water units are contracted and working. A few newbuild semisubmersibles rated to drill in up to 10,000 ft of water are destined for the Gulf of Mexico this year. One newbuild deepwater drillship also will enter the Gulf of Mexico drilling rig fleet this year as well. As many as 8 new semisubmersibles and drillships could be added to the US Gulf fleet by year-end.

In the Gulf of Mexico, **Global Marine's** SCORE (Summary of Current Offshore Rig Economics) had improved for 9 consecutive months. But while the Gulf of Mexico SCORE from January to February 2000 increased 1.7%, the February

2000 SCORE is still a 5.2% decrease from February 1999.

MAJOR OPERATORS INACTIVE

While the independents that have not had to completely rebuild their balance sheets have been fairly active on the Shelf, major operators have been quiet for much of the time that oil prices have rise. And for some drilling contractors, spending by the majors is what may turn this business around this year. Many drilling contractors and analysts expect that to happen during the second half of this year or in 2001 as deepwater activity increases, which primarily is a major-dominated area.

"Until we see the majors start coming back into the business," said **Jeff Chastain**, Director of Investor Relations with **Transocean Sedco Forex**, "I think you are looking at a business in the US Gulf that could be defined as flat in the first quarter."

"(Oil prices) have been very favorable for operators yet we have not seen a response to any degree from them," Mr Chastain said. "As we move toward mid-year and beyond we probably will begin to see a gradual improvement, particularly in the ultra deepwater."

"There is a lot of concern about the stability of oil prices and where they might go after the run up," said **John Gabriel**, Vice President of Marketing & Contractors for **Diamond Offshore**. "The most opportunity is in the deep water where the majors just totally pulled in their horns the last part of last year and let their contracts expire on some of the deepwater rigs."

"But (the majors) have a heavy lease position," Mr Gabriel said. "There is no way they are going to be able to evaluate what needs to be evaluated with the rig capacity they have committed. My expectation is that the deeper water will become more active as the year progresses."

"I don't think it's surprising to see a little caution on the part of integrated companies," said **Mike Dawson**, Vice President of Investor Relations for Global Marine. "They tend to spend last year's cash flow where the independents spend this year's cash flow."

WHY NO E&P SPENDING?

Marshall Adkins, Managing Director of the Energy Research Division of **Raymond James & Associates** in Houston, said in a recent report that E&P companies have been unusually reticent to plow their strong cash flows back into exploration. Mr Adkins says although oil prices and E&P cash flows have appreciated substantially, E&P companies have yet to increase activity levels.

"Could it be the phrase 'investment rate-of-return' is finally entering the vocabulary at many E&P companies?" Mr Adkins asks.

Mr Adkins believes there are 6 possible reasons for a more conservative spending approach on the part of E&P companies:

• A belief by E&P companies that these higher energy prices are not sustainable;

• The possible change in focus at E&P companies on return on capital rather than absolute growth in reserves and production;

• A temporary reduction in major oil company activity caused by mega-mergers;

• A lack of available people;

• A lack of prospects to be exploited;

• A lack of reasonably priced public capital to chase available prospects;

Industry doubts the sustainability of current higher oil and gas prices. E&P companies are reluctant to commit to oil prospects that require $20-plus oil prices to be economically justifiable, even though oil prices are in the $30/bbl range, Mr Adkins reported. He says only time will cure that issue, but if available prospects do exist then oil companies are likely to accelerate oil drilling in the second half of 2000 as long as prices remain above $25/bbl.

Mr Adkins adds that there is no doubt that consolidation and cost cutting by major oil companies has artificially slowed activity. However, he says, assuming there is not another round of mega-mergers, the industry should experience an upturn in activity in 2001. The greatest near-term impact will be in deepwater and international areas, the focus of most larger oil companies.

Mr Adkins says that E&P companies historically have generated a miserable return on invested capital. But he believes that many E&P companies have "found religion" and are focusing on projects that meet higher economic hurdles. He says they will continue to focus only on their highest rate of return prospects until they become comfortable that prices will be sustained.

According to Mr Adkins, several E&P companies have suggested that they may lack the personnel required to significantly increase E&D spending over currently budgeted levels. The layoffs and downsizing in the industry over the last 15 years, combined with a strong US economy, he says, are likely to create a significant personnel shortage over the next several years.

Mr Adkins believes that currently depressed drilling activity relative to strong commodity prices is a short-term phenomenon that only lends further near-term support to energy prices. If energy prices remain strong and activity levels continue depressed, he says, then sustainable higher energy prices become a self-fulfilling prophecy: The lower the activity levels, the higher the likelihood of sustained high energy prices.

Jim Rollyson, oilfield research analyst at Raymond James & Associates, agrees: Majors are still using $13-$14-bbl oil. "But a recent change in commentary from **Shell** is that they expect oil prices to be north of $20 for all of 2000. Chevron made comments that are more or less similar.

"But at the same time," Mr Rollyson continued, "Shell said they are still trying to prepare to be profitable in a $12 environment and be able to sleep at night in a $10 environment. At some point they have to wake up."

"Budgets for most of the companies other than independents were set sometime last fall when there was a universal belief that $25 oil would never stick," said **Allen Brooks**, Executive Director of Equity Research **at CIBC World Mar**kets in Houston. "It was that fear that kept a lot of companies from putting much into their budgets for the first part of this year. So now we've -ad $30 plus oil and companies have a lot more money."

However, Mr Brooks continued, "A lot of companies don't spend because they are committed to their budgets, which are not going to be reviewed until the second quarter. But they are going to recognize that whatever level oil prices settle, they are going to be much higher than anybody thought. Consequently, more projects are economical, their budgets are going to be ballooning up and they will begin spending."

WHEN WILL DEEPWATER REVIVE?

Most believe that deepwater drilling activity is going to play a major role in reviving the Gulf of Mexico. But just when is the deepwater segment of the US Gulf going to come back to life?

"The deepwater is clearly one area where you are seeing increased capital spending," said **Ken Sill**, an oil-service analyst with **Credit Suisse First Boston** in Houston. "There are more rigs now than the last cycle and there is room for more equipment."

"As far as the deepwater goes," Raymond James' Rollyson said, "late 2000, possibly some activity in the third quarter, but late 2000 and into 2001 is when deepwater activity is going to return."

"Operators, for a number of reasons, do not have the number of programs and the continuity of programs (in deepwater) to absorb all the rigs in the fleet right now, Mr Brooks said. "I think that it is a combination of (previously) low oil prices and there have also been some very significant dry holes that people have drilled."

"There were some prospects that were planned and all of a sudden they drill a dry hole and that throws the schedule out the window."

In fact, **Vastar** recently announced a dry hole on its Anvil prospect in approximately 5,400 ft of water in Mississippi Canyon Block 815. The well was plugged and abandoned after finding non-commercial quantities of hydrocarbons.

"So I think you are looking at the end of the year or early next year before activity picks up," Mr Brooks said. "That's following the idea that once oil prices settle out then people will be much more comfortable going out and kicking off a lot of projects."