Is the Gulf of Mexico the dead sea? Not by a long shot, judging from operator investments

By Jerry Greenberg, contributing editor

THE US GULF of Mexico has been called the Dead Sea more than once in the last quarter-century, and some companies are beginning to think that again – at least as far as the shelf is concerned. However, many companies working in the Gulf today will tell you it’s far from even being ill.

Deepwater is going gangbusters and expected to continue at an extremely high activity level based on the number of deepwater and ultra-deepwater rigs entering the region. Recent lease sale activity also bodes well for a strong deepwater market.

The fact that several new operators were formed during the past couple of years, including one that is less than a year old, attests to the fact that there still are potential opportunities for those willing to exploit them. Interestingly, two of the new operators are taking completely opposite approaches to their business strategies in the Gulf.

The shelf market has been taking a lot of bad-mouthing lately. Drilling contractors continue to mobilize jackups to other regions where high dayrates and, perhaps more importantly, long-term contracts, abound. There aren’t many prospects on the shelf that make economic sense, some say. However, one new operator is focusing strictly on the shelf while at least one major operator, Chevron, never left the shelf and doesn’t have plans to abandon it in the foreseeable future.

Despite the approximately dozen and a half jackups that exited the Gulf over the past two years, there presently appears to be a sufficient number of jackups to satisfy demand. However, some may require modifications to continue working in specific areas of the Gulf, one operator noted. Chevron is calling for a step-change in the way wells are drilled on the shelf and notes that there are opportunities to make drilling in shallow waters more efficient and less costly.

A GOOD SIGN

If anyone needed a good sign that the Gulf is not dead, not even the shelf, one only has to look at the two most recent Central OCS lease sales. Sale #205 in October 2007 resulted in operators submitting high bids of $2.9 billion, the second-highest in leasing history at that time. The sale also ranked second in the number of blocks receiving bids: 1,428 bids on 723 blocks from 84 operators. About 40% of the blocks receiving bids were in 5,249 ft of water or deeper, with the deepest block receiving a bid in more than 10,000 ft of water.

Recently established oil & gas company Dynamic Offshore Resources is moving a Nabors platform rig to South Pass Block 60 to drill additional development wells.

Two Operators, Two Strategies

One indication that the Gulf is still active involves recently established companies formed and operated by industry veterans. Cobalt International was established in 2005, and Dynamic Offshore Resources (DOR) has been in existence for only a few months.

DOR acquires and develops producing properties on the shelf. It recently received a $500 million investment from Riverstone Holdings and the Carlyle Group, and the company said it plans to concentrate its funds on Gulf of Mexico assets that are viewed as out of favor or neglected but still have viable growth and profit opportunities.
With the major oil companies, large independents and other public companies exiting the Gulf of Mexico shelf,” said Matt McCarroll, DOR CEO and co-founder, “market conditions are very favorable for (companies like Dynamic Offshore Resources).”

Mr McCarroll was previously president of Gulf of Mexico-focused Maritech Resources. His DOR co-founder is Mike Moreno, who is founder, chairman and CEO of Moreno Group. Together, DOR and Moreno Group recently purchased 75% of SPN Resources, the oil and gas subsidiary of Superior Energy Services. The acquired properties, all on the shelf, include approximately 180 producing wells with a current net production of about 11,000 bbl/day of oil equivalent.

SPN Resources’ engineers and employees have moved to DOR as its core staff and will continue to work on the company’s Gulf of Mexico properties. “There will not be any transition period, and we will immediately begin our efforts to exploit the properties and seek other acquisitions,” Mr McCarroll said.

The properties include 44 platforms, with the largest on South Pass Block 60. DOR is presently moving a Nabors platform rig to the structure to drill additional development wells. The company will use two more rigs on other platforms on the shelf. “We may use a jackup on a couple of locations,” Mr McCarroll said, “but only because the platforms aren’t big enough for a rig.

“Most of the platforms in South Pass 60 can accommodate rigs, but not necessarily all of the fields,” he continued. “We are going to start numerous operations in March that should result in increased production.”

The company may participate in lease sales, but that is not its primary focus. It is also investigating additional acquisition opportunities that Mr McCarroll declined to discuss. “The offshore fields are essentially all fixed costs,” he explained, “so my operating costs are going to be the same whether I’m producing 1,000 bbl/day or 4,000 bbl/day. You want to add volume.”

Cobalt International’s strategy differs from DOR’s in that it not only is expanding its company via lease sales but it also is focusing on deepwater. In Central Gulf Lease Sale #206, the company submitted high bids on 24 blocks as lead bidder and 12 more blocks as a partner with BHP Billiton and ENI Petroleum, all in deepwater, with several in 6,000 ft of water or deeper. Its total bids was the second-highest in the sale, nearly $451 million on 65 blocks. Cobalt also submitted the second-highest number of high bids, 36 totaling $589 million, including the third-highest bid of the entire sale — an offer of more than $85 million for Green Canyon Block 58.

In the Central Lease Sale in October 2007, the company was high bidder on 50 blocks, all in deepwater.

Like DOR, Cobalt received an infusion of investment money beginning in 2005 when Goldman Sachs committed $500 million to the company. Since then, Riverstone Holdings, The Carlyle Group and KERN Partners have invested, with the most recent a $350 million commitment by First Reserve Corp. All together, these firms had invested more than $1 billion in Cobalt when it went into its lease acquisition mode.

The company said it had planned for those lease sales for some time, noting that a significant number of deepwater, 10-year leases would be expiring and available in those sales.

“The whole point of Cobalt’s existence is to take advantage of those two extremely important lease sales,” said Cobalt president and COO James Farnsworth, also an industry veteran whose experience includes serving as BP’s vice president of worldwide exploration and technology. “We are a deepwater company. That is where our experience and background is, and that is why we chose to focus on acquisition from lease sales rather than deals or acquisitions of a company.

“The reason we took this approach is because there was an important turnover of deepwater leases,” he said. “Many of them have not been drilled or they have been drilled for only shallow targets. There was an enormous increase in quality opportunities that became available.”

In every case, what attracted the company to the particular blocks were subsalt opportunities at 25,000-35,000 ft targets. When the leases were acquired 10 years ago, he noted, they were acquired for much shallower geological opportunities. “The technology has moved on in 10 years in terms of deepwater drilling but also at much greater depths.”

Significant advancements have been made in seismic acquisition techniques and data processing, enabling the industry to see much better below salt. “It still is not perfect by any means, but you can clearly identify large structures below the sale,” Mr Farnsworth explained. “That is what attracted the high-dollar bids.”

In some cases, the company will conduct additional seismic acquisition, but it’s working at maturing these leases by drilling them within the next three years and is in discussions with driller contractors to secure deepwater equipment. The contract could be in the form of a rig-sharing agreement, but Mr Farnsworth said Cobalt is primarily looking for a rig.

“We are growing our company through successful exploration,” he summed up. “It is not through acquisition of existing production.”

**Both Sides Now**

While it may seem that many major operators and some large and small independents have forsaken the Gulf of Mexico shelf, Chevron is one operator that has carefully balanced its opportunities on the shelf and deepwater and ultra-deepwater. The company says it is still the largest player on the shelf and intends to stay that way. The operator also is one of the most active in deep- and ultra-deepwater.

“We feel like we have an advantage on the shelf,” said David Payne, vice president, drilling & completions, for Chevron.
“We have a very significant infrastructure, a highly talented workforce, and we know the business well.”

That doesn’t mean its business is going to be simple, however. “If we continue to do business as usual in the Gulf, then the shelf is finished,” he said.

Step-changes will be required to get additional resources out of the shallow water Gulf, he said, and the company is working on several of those step-changes, though he said he couldn’t discuss any presently.

There are opportunities for change, he said, in the way the industry uses technology to challenge its completion practices, the way it manages sand, consolidate infrastructure to gain efficiency and to use casing drilling to allow operators to get through depleted sands more efficiently. Service companies also need to be aware of the challenges, he said, and one challenge is the cost of goods and services.

Mr Payne said he would like to see upgrades in certain equipment on jackups. Some of Chevron’s shelf properties are in water as shallow as 10 ft, and it’s impossible to get a 400-ft jackup in that depth. The company expects to drill in the shallow water Bay Marchand area for some time, he noted, and that could provide an opportunity to partner with a drilling contractor to make rig modifications to a small jackup such as on offline pipe handling, logging, etc.

“There aren’t easy answers, and it requires investment to make it happen,” he explained. “It’s about sitting down with engineers who work in the field and tell them this is what I need to drill these wells, now how do I make that happen and how do I make it more efficient?”

For Chevron’s part, the company changed its business model on the shelf and no longer hires rigs on a well-to-well basis. “We will not put a rig on contract unless we have a firm six months work for it,” he said. “We have a core fleet of rigs that we are going to continue to operate.”

In deepwater, Chevron has a portfolio of deepwater and ultra-deepwater leases that are expected to keep several state-of-the-art drillships busy for several years. “The question is, is there a robust queue of work for every operator that signs up a rig? And is every rig really fully utilized or will there be some (exploration) disappointments that could cause those rigs to come back on the market and soften deepwater dayrates?” Mr Payne asked.

Chevron is comfortable that it has a strong lineup of deepwater prospects to drill. When the company charters its deepwater rigs, it generally looks at contracting them for a 100% stay in the Gulf of Mexico, or West of Shetland, or West Africa, for example. However, the company also looks at everything on a global perspective and has mitigation plans in place if a particular geographic area fails to live up to its exploratory expectations. “That allows us to take some bets (on rigs) that we wouldn’t have been willing to take previously, worldwide and in the Gulf of Mexico.”

Mr Payne also noted that the company does not have any rig-sharing contracts, preferring to keep the option in house. Chevron has three deepwater rigs under contract in the Gulf and five-year contracts for two Transocean drillships under construction. The rigs, scheduled for delivery in 2009 and 2010, are intended to be used 100% of the time in the Gulf. They will be rated to drill in up to 12,000 ft of water and down to 40,000 ft.