Outlook: Short-term uncertainty, long-term strength

FOR THE GLOBAL OIL market, there are "hundreds of outcomes."

That's the view of **Robert E Ford**, Vice President and Senior Oilfield Service Analyst at **Sanders Morris Harris**, Houston.

In the near term, he expects lower demand to make it more difficult for OPEC to manage the market. As a result, light sweet crude prices are likely to be in the "mid to low 20s" until economic growth picks up again.

"But there could be short-lived spikes as a result of counter-terrorism activities," he said.

"The long term could be very bullish (for oil and gas related stocks). But the near term will be marked by increasing uncertainty."

He outlined his expectations for commodity prices and drilling activity during a panel discussion at the IADC 2001 Annual Meeting, 28 Sept, in New Orleans. The popular "analysts panel," featuring the outlook for markets, prices, activity and challenges to the drilling industry, is a highlight of recent annual meetings.

"We started getting very nervous (on stocks) in March and April," he said.

"The length and depth of the recession is still uncertain, but it looks like stocks may be close to a bottom."

Indeed, within days of his comment, many oil and gas company and oil service company stocks posted good gains.

GAS MARKET FUTURE

With natural gas prices below \$2/MMBTU as the IADC Annual Meeting convened, it was easy to have some doubts about the long-term future of gas. But over the long term, because natural gas is a finite, regional resource, its price will continue to move higher, said Mr Ford.

Natural gas will remain under pressure at least till year-end, he said. The coming US winter has to be colder than the one just past if it is to cause the gas market to firm up soon.

But a sustained period of gas market strength could begin by late in the second quarter or early in the third quarter of next year, he said.

Growth in electricity demand will continue to be a key driver of natural gas markets.

"As generating capacity comes on stream, electricity prices will continue to go lower, but that could take years, depending on the pace of deregulation."

As electricity continues to be deregulated, there will be price spikes. Mr Ford expects more spikes to the upside because industry will "overdo on the downside" by pulling too many rigs out of service, he said.

"The lower the rig count falls, the more violent the upside."

It will take more rigs on gas prospects just to keep up with demand and reservoir declines. Despite the fact that about three quarters of US rigs have been drilling for gas in recent years, "over the last 2-3 years, we haven't done much for gas supply," said Mr Ford.

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>
> **—Robert E Ford**
> **Sanders Morris Harris**

Gas production began to decline 4 months after this year's peak in drilling activity in July.

The overall decline rates of natural gas reservoirs in the US have increased significantly in the past decade.

That coupled with expected robust growth in US natural gas demand puts growing pressure on industry to find and develop new sources.

ACTIVITY LEVELS

"Increased uncertainty and low gas prices equal lower commodity planning price assumptions," said Mr Ford. "And that equals lower capital spending."

He expects oil and gas company capital spending to be 15% lower in 2002 in the US, though higher spending outside the US will result in a world total that is "about flat."

"But if gas prices move up, budgets will be overspent."

Operating cash flows today determine the level of activity in 6 months, said Mr Ford. He expects the US rig count to drop to an average of about 900 before moving higher again. Even though rigs drilling for gas far outnumbered those drilling oil prospects in recent years, Mr Ford still finds crude price the best predictor of drilling activity.

In the US, he expects the rig count to drop to 1,000 by year end, then decline further, reaching the predicted low point in this cycle of about 900 in the first quarter of 2002.

Plotting crude price against the international rig count indicates an international activity level of about 785 rigs by year-end, he said. "The international count should be plus or minus 50 rigs from today's level."

Drilling outside the US typically involves larger firms with bigger balance sheets working on longer-term projects, said Mr Ford. That tends to bring more stability to international drilling.

CONTRACTOR IMPACT

In the near term—defined as 3 months—Mr Ford forecasts increasing economic and political uncertainty that will bring lower multiples on corporate earnings. And drilling contractors are likely to have lower earnings because of declining activity. Liquidity will be important.

"It will be tough to do well in the near term," said Mr Ford. "Historically, the (oil service) group bottoms about 6 months before activity bottoms."

But it is a "great trading opportunity," he said.

After the bottom of the cycle, when does the oil service group start an upturn?

"We're close to a bottom," said Mr Ford. "And a sustainable upturn usually begins about 2 months after the bottom."

In the medium term—defined as 4-12 months—Mr Ford expects stocks to be higher a year from now. OPEC will be a key to how oil markets behave, he said. "OPEC ended the last cycle and it has started this one."

Beyond 12 months, Mr Ford feels the outlook is very positive. The terrorist attack on the US on 11 Sept points up the fact that adequate oil and gas supplies is now an even more critical security issue. He warned that embargoes against oil producing countries could result from anti-terrorism activities.

Security concerns related to energy will now have a much higher priority, said Mr Ford.

For example, "We are going to drill on the Arctic Natural Wildlife Refuge in 2-3 years," he predicted.

LESS VOLATILITY? NOT LIKELY

"The future looks just like the past," said **George Littel**, Partner, **Groppe, Long & Littel**, Houston.

He was describing his outlook for natural gas prices over the next 3-5 years during the panel discussion on the industry's future at the 2001 IADC Annual Meeting. He expects the average price of US natural gas will be between $4.25 and $4.50/MMBTU, with lows of less than $3 and highs of over $5. "The price of gas can turn very fast and it is not going to settle down," said Mr Littel. "Gas prices could be back above $5/MMBTU before too long."

"When electricity markets catch a cold, the gas market gets pneumonia. A 1% change in total electricity generation means a 10% change in the consumption of natural gas for power generation."

—George Littel
Groppe Long & Littel

One key to reducing volatility in the natural gas market is what happens in the electricity market. When gas gets to be "less important" in electricity generation, gas markets will be less volatile.

Mr Littel noted that today's weakness in gas prices results from a weakness in demand rather than strength in supply. Declining demand—not a growing supply—was also the cause of the "gas bubble" that existed through much of the 1980s, he said. Then, part of the drop in demand resulted from the federal Fuel Use Act that prohibited using natural gas as a fuel for power generation. The Fuel Use Act was repealed in 1988.

Now, electricity generation is very important to natural gas.

"When electricity markets catch a cold, the gas market gets pneumonia," he said, noting that a 1% change in total electricity generation means a 10% change in the consumption of natural gas for power generation.

Working gas in storage is a key to market volatility. But storage levels are "eminently predictable," said Mr Littel. Normal storage level is about 2,800-3,100 bcf, he said. Storage volumes are in that range now as the heating season begins.

NOT THE ANSWER

There are a number of business and financial strategies to deal with commodity market volatility. But dramatically cutting staff when prices weaken, then rebuilding an organization on a crash timetable may be one of the least appropriate responses.

"Industry may find that downsizing over the last couple of decades was extraordinarily counterproductive," said **Aliza C Fan**, Vice President and Petroleum Analyst, **John S Herold Inc** during the analysts panel discussion.

Though strong oil and gas prices historically meant an increase in staff, last year the top oil companies cut about 20,000 jobs even though industry was in a high price environment, she said.

There is now only a trickle of new entries into the industry, and the knowledge and experience assets of the older professionals in earth sciences and engineering are drying up, she said.

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John S Herold Inc

"Downsizing in the past has been overdone." The oil and gas industry is now second highest in revenues per employee.

And there is increasing concern about safety issues, for example, on rigs operated by less-experienced crews.

Volatility has taught companies to rely on efficiency and technology for financial success, she said, not on commodity prices. The industry needs to stop viewing downsizing as a quick fix. That approach leads to recruitment problems and hurts the industry's image as a place to build a career.

According to the **Bureau of Labor Statistics**, said Ms Fan, the oil and gas industry is expected to experience a decline of 6% in employment prospects between now and 2008, the worst employment prospects of any industry.

And the decline of 71% in petroleum engineering students since 1985 will have a dramatic impact on industry's ability to meet expected energy demand.

"Taking a job in the petroleum industry is just too risky," is how Ms Fan described the perception of many students today.

She complemented **Rowan Companies Inc** on its policy of not downsizing during market slumps. She said that policy obviously contributed to Rowan's impressive record of retaining supervisors, saying the company's turnover at the supervisory level is "zero."