

Outlook for 2003 more positive, say analysts

WHILE SEVERAL ANALYSTS have pretty much written off the remainder of 2002, there is some hope for next year as slightly increased E&P budgets are expected, which in turn could mean higher drilling activity worldwide. Oil prices could drop to “more normal” levels in the low \$20s that could spur consumption. Natural gas is expected to drive North American activity but the Iraqi question, hangs over the entire industry as many believe the ultimate impact and timing in terms of oil prices will depend upon if and when a war with Iraq begins, how long it will last and how friendly any new regime will be.

GEOPOLITICS OF OIL

Amy Myers Jaffe, Senior Energy Advisor and Project Coordinator for Energy Research for the **James A Baker III Institute for Public Policy** at Rice University, helped to put into perspective the intertwined and changing landscapes of global oil and gas geopolitics since September 11, 2001. Ms Jaffe presented a quick tour around world geopolitics at IADC’s annual meeting in September.

Ms Jaffe noted that despite changing American attitudes toward the Middle East region generally, the US’s ties to that region are still strongly linked.

Iran, Iraq, Syria, Sudan and Libya, which the US State Department refers to as countries of concern, produce 8 million b/d, more than 10% of the world’s oil supply. Saudi Arabia alone produces nearly 10% of the world’s oil.

“The reality is that Saudi Arabia has been a fairly steadfast ally for three decades in terms of the world oil market,” Ms Jaffe said, “and they are in a critical role where there is really no substitute, no replacement.”

Turning to Africa, Ms Jaffe notes that China increasingly imports oil from the region as well as the Middle East but US markets also rely increasingly on Africa. That reliance could increase if South American production doesn’t keep pace.

“The promise of oil and gas in South America is really drying up,” she said.

She noted that African production could double to over 10 million b/d by 2010.

Russian oil supplies are increasingly important to Europe and Asia. She said that a lot of the Russian suppliers are going east rather than west, however, and have already improved their relationships with Japan and China.

“When we think about Russia,” Ms Jaffe said, “we need to think about them as a player in the Asian market.”

However, she also noted that in export terms, Russia isn’t close to catching up

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**Mark Urness
Salomon Smith Barney**

with Saudi Arabia, which exports 7.84 million barrels per day compared with Russia’s approximately 4.3 million barrels per day.

She also said that Asian reliance on Middle East and African oil imports is expected to grow. In 2001, Asian demand was 20 million b/d. That is expected to grow to 29 million b/d by 2010 and 37.5 million b/d by 2020. To meet that demand, however, oil imports in 2001 totaled 14 million b/d. By 2010, imports are expected to grow to 22.6 million b/d and to nearly 33 million b/d by 2020.

Local oil supply, which contributed 6 million b/d in 2001, is expected to grow modestly to 6.4 million b/d by 2010 but then to fall significantly to 4.7 million b/d by 2020.

OIL PRICING

Several analysts predict that the price of oil in 2003 could drop to a more “normal” range in the low \$20s. This could have the effect of increasing demand to see more E&P activity. The average oil

price the past 10-15 years, according to **Mark Urness**, Vice President of **Salomon Smith Barney**, is around \$20 per barrel, which he expects to see, particularly after any kind of resolution in the Iraq situation.

Dan Pickering, Managing Director at **Simmons & Company International**, said \$30 crude oil is nice for the industry but it also is something that should not be counted on as the industry moves forward. He said current crude prices are too high for the longer term.

“High prices, declining demand and rising supply are not sustainable for a \$30 crude price environment,” Mr Pickering said. “We think crude prices could be in the mid \$20 area.”

“Longer term I think the supply and demand issue is going to have to work itself out,” he continued, “but shorter term our 2003 price could be about \$25 per barrel.”

Susan Farrell, Senior Director at **Petroleum Finance Company**, has a contrarian view of oil prices and its impact on the industry.

“Saudi Arabia is extremely conscious of the fact that if the price drops down to \$15 per barrel, people drop out,” she said. “The idea of a nice price of \$22 per barrel for the next five years may not be the best strategy for this organization.”

Ms Farrell sees a surge of new production coming on the market that is going to cause a shift in OPEC, but she emphasizes that OPEC is not going to keep the oil price at \$22 per barrel.

NATURAL GAS

Natural gas demand fundamentals are improving, according to Mr Urness and he expects demand to increase 4% in 2002 due to stronger economic growth and the return of switchable demand. US power generation was up 2.8% in the second quarter year over year. He expects electricity demand to be about 80-85% of Gross Domestic Product (GDP) growth. He is forecasting 2.7% US GDP growth in 2003.

Salomon Smith Barney’s 2003 natural gas price forecast is \$3.50 per million Btu. This assumes that 4 bcf/d of gas is

lost to fuel switching as oil prices fall toward the company's expected price of \$20 per barrel.

Gas storage has been at record high levels for some time, Mr Urness said, and the market is on target to reach a level of storage that is above the level in November 2001. However, he believes that storage surplus will largely disappear by March 2003.

Mr Pickering concedes the gas storage is high but said the beauty of that inventory is that it resets every year.

"We are calling it a seasonal issue," Mr Pickering said. "We think it is going to be addressed as we move forward into 2003."

US natural gas demand is down 2.8 bcf/d since 2000, Mr Pickering said, and most of that results from lower industrial demand. However, he noted, electricity demand has been a savior with gas demand up 3 bcf/d.

One slight offset, he says, is that gas production is also falling. Supply is not growing with the rig count.

Mr Urness agrees. "Productivity per gas rig is decreasing, particularly in the onshore segment," Mr Urness said.

"Once beyond about 500-600 rigs drilling for gas a dramatic reduction in incremental productivity per rig occurs," he noted. "Last year the industry averaged about 930 rigs drilling for gas and we barely moved the needle on deliverability."

He said this year the industry will average about 710 rigs drilling for gas but when the figure approaches 800 rigs there will be fairly marginal production increases. Productivity per rig has declined dramatically since the early 1990s when each rig added an average of 25 MMcf/d of gas. That figure has decreased to about 14 MMcf/d.

Despite lower productivity per rig, Mr Urness said that with gas prices at about \$3.50 the industry should expect about 700 rigs drilling for gas. However, he believes the industry could reach around 800 rigs drilling for gas next year.

Natural gas production decline rates are also accelerating, he said, but that appears to be stabilizing at about 30-

31%, which is the level predicted for this year.

E & P ACTIVITY

With oil prices hovering around \$30 per barrel and natural gas prices above \$3.50 per MMBtu, the question of the day is why aren't oil companies spending money on exploration?

Mr Pickering believes that with natural gas inventories so high, E&P companies are not going to bet against inventory levels in terms of what their price expectations might be.

"That is an overhang on the market," he said, "but as we move into November and December that overhang is removed. We will know how much gas will be in storage when we know how quickly supply is falling."

Economic concerns play an important role in E&P spending as well. When companies are worried about lower demand resulting from the economy, they don't spend as aggressively.

A third issue is prospectivity related. "Some companies have drilled through their inventory and some haven't," Mr Pickering said, "but it will certainly be an issue for some time."

Also, Mr Pickering noted, E&P companies that tend to be the most nimble and reactive to pricing are very capital constrained. "The market is not giving anybody any money these days, so the companies that might get more aggressive in this (price) environment may not have the cash."

Again, Mr Urness agrees with the assessment. "The 10 year average of capital expenditures and cash flow being reinvested shows that about 53% of the majors' cash flow was invested in the upstream side with the independents averaging about 95% investment."

This year, however, Mr Urness said, while the majors are going to be at their average level, independents are going to be below 80%. "We think independents are more oriented toward return on capital," he said. "We also think they are somewhat prospect inventory limited."

Mr Urness does hold out hope for 2003, though. "The independents' cash flow is expected to be up about 12% in 2003," he explained, "and with a constant rate of

reinvestment we would be looking at about a 10% increase in spending in 2003."

Deepwater exploration and production in 1,000 ft of water and greater appears to be where most of the future money will be targeted, according to Ms Farrell.

"The top five players are going to spend at least \$12 billion a year on deepwater projects by 2004," Ms Farrell noted.

"If you add another 6-8 smaller players and Petrobras you are peaking at around \$20 billion a year by 2004 and 2005."

BP is focusing on the Gulf of Mexico, she said, but the rest of the top five companies are targeting West Africa.

Mr Urness noted that worldwide deepwater discoveries peaked in 1999 and decreased in 2000 and 2001. However, he said, through June 2002 the industry has seen an increase in deepwater discoveries and he expects there could be as many as 50 such discoveries this year.

"Discoveries have been down and success rates haven't been what they were in the late 1990s," Mr Urness said, "but there are still a lot of fields that have yet to be developed."

"The timing is the uncertainty," he added.

IMPROVED RIG COUNT

Mr Urness believes the worldwide rig count in 2003 could see a nearly 14% increase over 2002 with approximately 2,090 rigs working next year compared with 1,840 in 2002.

The US rig count is estimated to increase just over 21% to 1,025 rigs, with an average of 850 drilling for gas, a 20% increase over 2002, and 175 drilling for oil, nearly a 28% increase.

The international rig count, outside North America, is forecast to rise to an average of 745 rigs next year compared with an average of 725 rigs in 2002. Latin America, Africa and Asia Pacific areas are expected to post increases in rig count. Europe and the Middle East are forecast to record slight declines in their numbers. Mr Urness said should there be a war in the Middle East, the rig count figures could be even lower.

OFFSHORE

Salomon Smith Barney expects offshore utilization worldwide to be up slightly to 85% in 2003 compared with 81% this year due to higher utilization in the Gulf of Mexico, which Mr Urness said would be the result of deep gas drilling activity.

“Very few jackups are equipped to drill the deep targets and those contractors that have that type of equipment are going to have a good year next year in the Gulf,” Mr Urness said.

The analyst is forecasting a fairly significant increase in Gulf of Mexico utilization next year, up to nearly 83% from an average of just under 68% in 2002.

“That increase is not only the result of an increase in demand but also due to reduced supply,” he said. “We have seen 18 jackups leave the Gulf and we will probably see some floaters leave the Gulf as well.”

North Sea utilization is expected to fall

to 75% from 84% this year due to the UK tax increase. The decrease in utilization will primarily affect North Sea semisubmersibles, he said, rather than the jack-up market.

Mr Urness expects offshore dayrates to increase next year in the Gulf of Mexico and worldwide generally but to decrease in the North Sea where they are already dropping, particularly for semisubmersibles.

CHALLENGES AND OPPORTUNITIES

In summing up his outlook, Mr Urness said that the contract drilling industry is very well positioned for profitable growth in the recovery next year. The challenges to be aware of, he said, include weak demand for mid-water depth floaters and mat-supported jackups; an adverse impact of the UK tax increase and a slowdown of exploration offshore Norway; higher costs, for example, increased insurance costs; and safety and environmental challenges.

Opportunities in the future include deep gas drilling in the Gulf of Mexico; new opportunities in Mexico and India; some new deepwater development projects moving forward; and the continuing industry consolidation.

Mr Pickering noted another challenge the contract drilling industry faces.

“E&P companies talk about high quality assets, experienced crews and drilling efficiency,” he said. “Some companies will pay for that but the E&P industry as a whole has not had to pay for that in the past because the service industry has been too willing to add capacity.”

“The challenge has been getting returns for that,” he continued. “I think about that as the customer wants to drive a Porsche and make payments for a Honda.”

“So as we go forward,” Mr Pickering continued, “one of the challenges is to make sure you get paid for the money you spend.” ■