Chevron working to partner with contractors

By Linda Hsieh, Associate Editor

"THE RIG MARKET is a funny business," said **Kevin Lacy**, Vice President of Global Drilling and Completions for **Chevron Corp**. "The variations in rates are not always logical."

For the past 4 years, he said, Chevron has been working with drilling contractors to recognize this and to build strong strategic working relationships that can benefit both sides.

A good example of that effort would be the 5-year deepwater drilling contract for a newbuild and the multi-year extensions for 2 deepwater floaters that Chevron recently awarded to **Transocean**. Under the deal, Transocean will build an enhanced Enterprise-class drillship that will begin working in the second quarter of 2009. The dynamically positioned, double-hull drillship, to be named the Discoverer Clear Leader, will be constructed in South Korea over an estimated period of 30 months. It will feature Transocean's patented dual-activity drilling technology and will be capable of drilling in water depths of up to 12,000 ft.

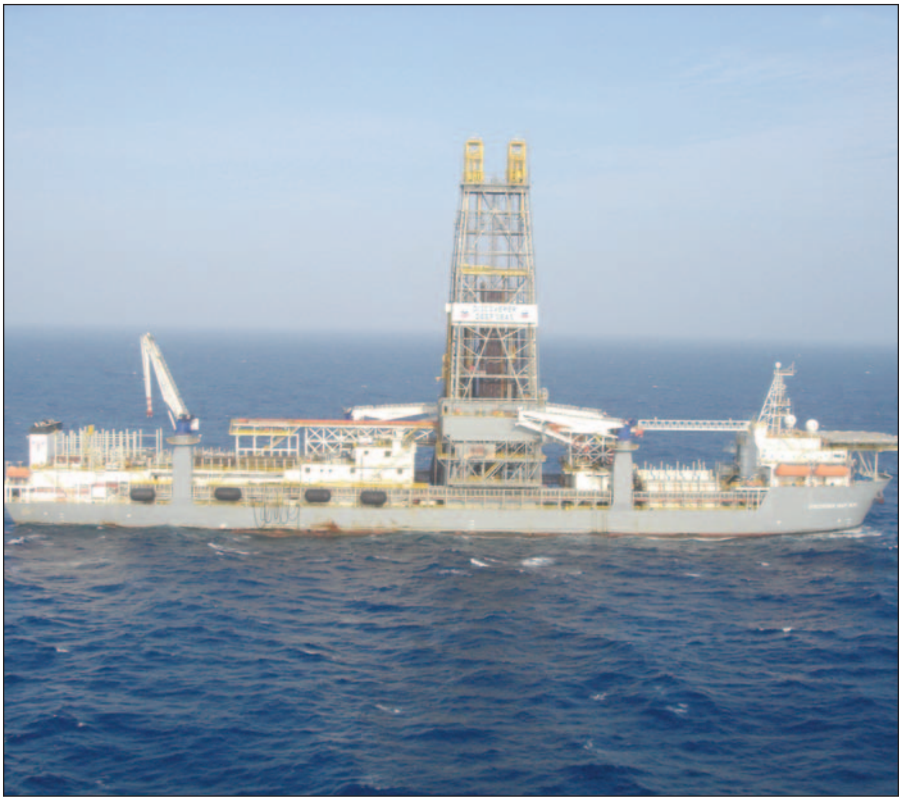
Kevin Lacy

Simultaneously, Chevron awarded a 2-year extension for Transocean's deepwater drillship Discoverer Deep Seas, to begin in January 2009, and a 2½-year extension to the deepwater semisubmersible Cajun Express, to begin in July 2007.

Combined revenues possible from the 3 agreements total approximately $1.7 billion over 10½ years.

"What Chevron did with Transocean was successful because we had established a very strong working relationship with them, which provided a framework for our negotiations," Mr Lacy said. "This allowed us to figure out how to set up this rig package so it makes sense for both companies. In the end, we were able to take a very sizable step together."

With Transocean needing a certain dayrate for return on its capital and Chevron needing some flexibility in the term and rates, the companies agreed on a flat dayrate for 3 years, then 2 years with rates linked to the standard West Texas Intermediate oil price with a floor of $40 per barrel and a ceiling of $70 per barrel. This newbuild contract, coupled with the 2 other extensions, provided Chevron with the rig flexibility it needed, Mr Lacy said, and the deal was a success.



Transocean's Discoverer Deep Seas is currently drilling production wells in the deepwater Gulf of Mexico at Chevron's Tahiti Field. Chevron recently awarded a 2-year extension for the rig.

"We knew we would take some exposure, especially on the initial fixed term for the newbuild, if rates begin to decline. But we felt that with Chevron's size and our strong focus on deepwater, the risks were offset. It was an intelligent risk," Mr Lacy said.

Although he felt the deal was an ideal model of a strong operator/contractor relationship, Mr Lacy said, he doesn't foresee many companies striking similar agreements.

"Except for a few companies, a rig package of this extent is just too hard for most to take on," he said. "Especially since the rate outlook for 2009-10 is questionable."

ACTIVITY LEVEL REVERSAL

Mr Lacy also noted that with the high oil prices and operators focusing on adding new barrels and increasing recovery from existing reservoirs, production constraints have suddenly shifted over to the services side.

"All operators, large and small, have upped their expectations on activity levels, so it's like everybody is rushing for the door at the same time," he described.

He also agreed that access to drilling rigs has been a universal problem for all operators, but added that it probably has been disproportionately hard on smaller operators in the deepwater market.

"Those who didn't have a steady queue were caught very short. If they can't offer a long-term spread or forecast a year or 2 in advance, that added to their competitive disadvantage," he said.

The jackup market has also tightened up, due to high utilization and last year's hurricanes. But that's been due more to prices than to equipment access, he said.

With historically high dayrates and unsatisfied demand in all markets, Mr Lacy said, there has been some frustration and strained relationships.

"Contractors have felt like they have been disadvantaged for many years, barely making their cost of capital. Now, rightfully so, they're seeing healthy profits," he said. "On the other hand, operators had become accustomed to getting rigs as needed and getting competitive rates. So the lack of flexibility now has been a bit of a rude awakening."

For example, the deepwater market poses "a real challenge," with operators having to look out 2 or 3 years in advance and make 3- to 5-year commitments. "That makes most operators very uncomfortable," he pointed out.

This is something that both operators and contractors will have to work through, he said. "Unfortunately, because the industry's in a state of flux, people are uncertain over how to address this.

"Through this year and next, the rig market will remain very market-driven and very much to the contractors' advantage," Mr Lacy said. "That's just the market. And as an operator, we can't take it personally."

DAYRATE INCREASES

Another industry concern Mr Lacy cited is the significant jumps in dayrates seen across the board in all rig types.

"While crude prices have gone up 50% to 75%, rig rates in some cases have gone up 200% to 300%. It's reached a point where it's impacting lower-tier prospects and well development," he said. "While commodity prices are high, the jumps in rig rates have gone beyond. They're not at an economically sustainable level."

Operators do see newbuilds coming out on the horizon, but Mr Lacy said he does not believe that capacity will impact rig rates until they actually become available. "Until there are 1 or 2 rigs stacked in each category, there won't be much softening in prices, and that's a couple of years out," he said.

THE GULF OF MEXICO

Deepwater development in the Gulf of Mexico continues to be the driving force in Gulf production and potential growth. In March, the US Minerals and Management Service announced that 10 new deepwater (1,000 ft or greater) oil and gas discoveries were reported in the Gulf of Mexico in 2005.

The number of rigs in the area also indicates the high activity level. As of mid-March, 42 rigs were drilling or working on development wells in deepwater. Ten of those are drilling in 5,000 ft of water or greater, compared with 6 a year ago.

Two of the 10 deepwater discoveries were made by Chevron — the Big Foot prospect located in Walker Ridge Block 29, approximately 225 miles south of New Orleans, and the Knotty Head prospect, located in Green Canyon block 512, approximately 170 miles southeast of New Orleans. These 2 discoveries "confirm the extensive middle to low Miocene play within the Mississippi fan foldbelt area," said **Chris Oynes**, MMS' Gulf of Mexico Regional Director.

Also last year, Chevron began the construction of production facilities for the deepwater Tahiti project in the Gulf of Mexico. As one of Chevron's "Big 5" capital projects, Tahiti "is a great example of what else we'll be doing going forward in the Gulf of Mexico and is reflective of our deepwater strategy," Mr Lacy said.

The other 4 of Chevron's "Big 5" projects are:

- Benguela Belize-Lobito Tomboco development in Angola;
- Sour Gas Injection/Second Generation Plant project at Kazakhstan's Tengiz oilfield;
- Gorgon LNG (liquefied natural gas) project offshore Western Australia; and
- Agbami Field offshore Nigeria.

'CHALLENGING' STORMS

With such heavy investment in the Gulf of Mexico, Chevron obviously was affected by last year's hurricanes.

"It made what was already a challenging year very difficult," Mr Lacy said. Even assuming that no significant damage comes out of this year's hurricane season, he added, it will be well into 2007 before Katrina and Rita's impact fades.

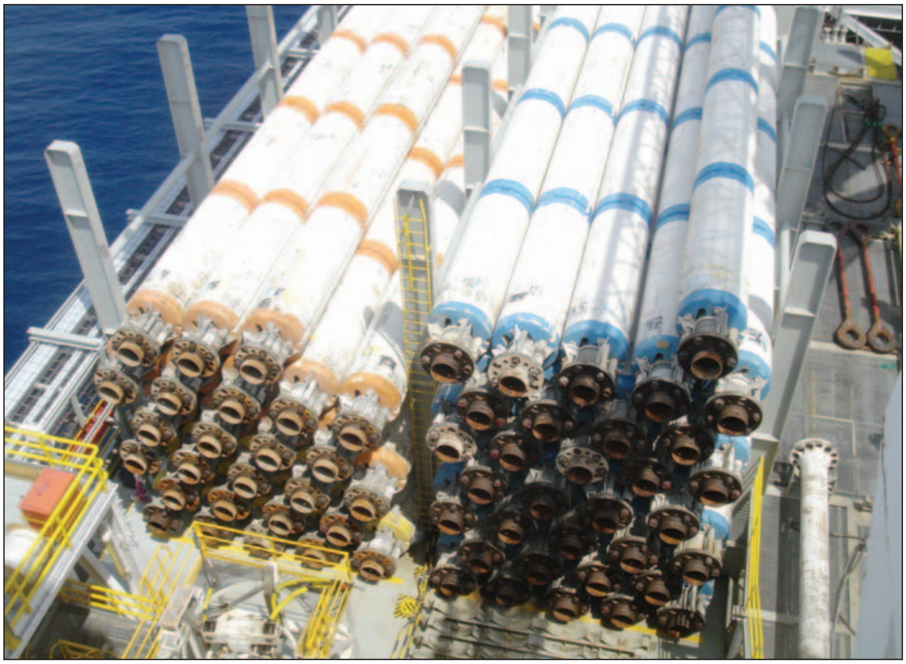
Knotty Head prospect well sets record for deepest well drilled in the Gulf of Mexico

In December, it was announced that the deepest well ever had been drilled in the Gulf of Mexico, according to the US Minerals Management Service. Chevron/Unocal worked with Weatherford International, Nexen Inc, Anadarko Petroleum Corp and BHP Billiton Ltd to drill a record-setting 34,189 ft (almost 6.5 miles) well on the Knotty Head prospect in Green Canyon Block 512. It broke the previous record set earlier in 2005 by Shell of 32,727 ft.

Weatherford's Hostile-Environment-Logging Measurement-While-Drilling (MWD) and Logging-While-Drilling (LWD) equipment was used on the job. Both have already set a new benchmark for downhole operating temperature and are rated to an industry-best 30,000 psi operating pressure.

In addition to setting a new depth record, the Hostile-Environment Logging equipment also transmitted real-time and recorded triple-combo log data in extremely hostile well conditions — in excess of 29,000 psi and 138 degrees Celsius.

"This equipment demonstrates a significant step-change in the industry capability that can enable production from previously unreachable reserves using existing infrastructure not only in the Gulf of Mexico but also across ultra-deep hydrocarbon resources around the world," said Bernard J Duroc-Danner, Weatherford's chairman and CEO.



Joints of drilling riser to be used in Chevron's Tahiti project are seen on a rig in the Gulf of Mexico. Last year's hurricanes and damages have raised concern, which may lead to regulatory changes and better industry practices, said Kevin Lacy, Chevron Vice President of Global Drilling and Completions.

The storms stirred a lot of concern that so much damage was inflicted by just 2 storms, he continued, and the government may make regulatory changes and the industry may adopt better practices.

BETTER HIRING

At the recent IADC/SPE Drilling Conference held in Miami Beach, Fla., Mr Lacy spoke at a plenary session on the industry's shortage of qualified personnel.

"Our initial response is to hire from each other, and that just makes the situation worse," he said. "We need to hire more new college graduates, more inexperienced hires, more hires from geographical regions we haven't looked at before. If we do these things collectively as an industry, we'll start to recover.

"But, we don't do anything very well collectively because this is such a competitive environment. So the short term is going to be quite messy. In the next 2-3 years, our operational and safety results will be challenged. In that short time frame, we're not going to solve a problem that was 10-15 years in the making."

PRICE CRASH UNLIKELY

While many industry veterans on the contractor side are worried about the considerable number of newbuilds on order, Mr Lacy said he doesn't think a crash in neither rig rates nor commodity prices will be likely. Oil prices likely will not persist in the \$60 to \$70 range, he said, but it likely also won't fall far below \$35-\$40, especially with OPEC's diminished spare capacity putting the petroleum market on much more of a market system.

But, Mr Lacy cautioned, the industry should look back and learn from history.

In the late '70s and early '80s, oil prices became artificially high due to supply restrictions. "It was bound to come back down. The industry's mistake at that time was they didn't think through why the prices were so high. Everybody got into the business, and then we went in for a very long price correction," he said.

Prices finally settled at around \$20-\$25 structurally. But he pointed out that now, two key reasons have raised structural prices: higher demand and less natural supply. "And political instability in many regions of the world add another \$10 to \$20 a barrel," he said.

But even if a price correction brings oil prices back down to \$45 a barrel, the industry shouldn't be too surprised, he advised. "It might seem like the world's ended — again. But if you look at the fundamentals of the oil and gas business, most projects can withstand that," he said. "We all learned how to be successful at \$25 a barrel."