Land activity could remain sluggish for some time

IT'S BEST TO PUT those sunglasses back on the shelf. The future doesn't look very bright at least for another six months, and possibly longer.

Operators' North American spending plans, including Canada, could be down as much as 20% compared with 2001 E&P expenditures. On the other hand, international spending is projected to be up maybe as much as 10%.

There are many reasons why domestic E&P spending is declining. Natural gas storage is up approximately 15% above normal for this time of year. Demand, especially from industrial consumers, is down significantly.

Natural gas prices, the main driver of the US onshore E&P activity, are in the doldrums and are not expected to begin increasing until summer, if then, depending upon the economy.

All in all, the outlook for the near-term market is not good. Beyond that time frame is anyone's guess, and there are plenty of those around.

In Salomon Smith Barney's annual E&P spending survey, North American spending was projected to decline by about 14.7% and international spending was projected to be up 9.7% compared with last year. However, due to lower commodity prices than forecasted, Salomon Smith Barney is predicting a decline in North American spending to be as much as 20% lower than in 2001. Likewise, international spending could be flat.

The average oil price assumption in Salomon's survey, which was conducted in December 2001, was $20.72 per barrel. At that time it was above the 12-months futures strip price. That has changed in mid-February when the 12-month futures strip price averaged 73 cents above the planning price. However, natural gas prices have remained lower than the operators' planning price of $2.83 per mcf. In mid-February the 12-month futures strip was $2.51, 32 cents below the planning price.

Due to lower gas prices, Salomon Smith Barney said that it expects the US rig count to average 845 in 2002, a 27% decrease from 2001.

That includes an average of 175 rigs drilling for oil and 670 rigs drilling for gas. The company expects the rig count to bottom out in the second quarter at 750-800 rigs and then to begin increasing during the second half of the year. It said, however, "the exact timing of the recovery remains highly uncertain."

TIMING A RECOVERY

It is anybody's guess as to the timing of the next up cycle. While many in and outside of the industry predict a turnaround beginning sometime during the second half of this year, the length of time continues to increase. Some analysts thought perhaps a recovery would begin in the third or early fourth quarter. Then it was fourth quarter 2002 or early first quarter 2003. Now some are saying it could be as long as 18 months. That would put a forecasted recovery beginning sometime around August 2003. Most analysts believe that the long-term factors are strong and inevitably there will be an upturn.

"Even though the rig count is stabilizing now," said Richard Mason, Publisher of *The Land Rig Newsletter*, "it is not likely to recover at the earliest until perhaps the fourth quarter of this year. Any rebound in activity even remotely similar to what we saw in 2001 would be a 2003 phenomena."

Stephen A Richards, Vice President of Drilling Operations for Key Energy Services, Inc., while declining to provide a time for a recovery, believes there is some light at the end of the tunnel.

"We had 74,000 megawatts of new gas-fired power plants brought online from 1999 to 2001," he said. "There are another 120,000 megawatts currently under construction and another 160,000 megawatts in active development, so certainly there are some positive things on the demand side.

"We also believe that the economic downturn on the industrial side has to be turning around. It is now in its 15th month, several months longer than any such industrial recession in our

Nabors Drilling Rig 797 was drilling for Barrett Resources in Wyoming. It is presently drilling for Anadarko in East Lost Hills, Calif.

history, so we suspect that things will improve on the gas side of the business."

Mr Richards said there are still some short-term pains to endure in the market but that long-term fundamentals are strong. "The supply and demand curve still works and they are not very far from being in balance."

The problem is an overabundance of gas in storage due to a mild winter plus the industrial recession. "If one of those disappears," Mr Richards noted, "it will improve gas demand at the same time supply is decreasing."

He believes the market will have to come back stronger than before. "We have proven this past year that we are not able to significantly affect gas supply with a 500-600 rig increase."

Dennis Smith, Director, Corporate Communications for Nabors Industries, believes there inevitably will be an upturn but the timing of that is pegged to the economy. "It is anyone's guess," he said, "but the worse the rig count gets and any bit of restoration of the economy, the quicker the upturn will be. We are already beginning to see declining production for public reporting companies."

Higher gas prices likely will be necessary to make drilling economical, to offset the risk of developing more gas and to earn a greater return. Gas reserves are smaller, less accessible, deeper and more remote. Almost all of the easy targets have been already drilled.

"A three dollar gas price is a wonderful thing for the industry. It is a fair price." Mr Mason says. "As it falls towards $2.50 it becomes a lot more uneconomical, and we are below that now."

DAYRATES AND EQUIPMENT COSTS

Dayrates in the US have fallen to about half of what they were less than a year ago. A 2,000 horsepower unit peaked at around $20,000 per day. The present dayrate range, depending upon horsepower and equipment, is generally between $7,500-$10,000.

Operating margins of $4,000 and $5,000 that contractors saw in the second and third quarters last year are now around $1,500 for leading edge rates and $1,000 in some cases, according to Mr Mason.

However, Mr Mason believes that dayrates, while still declining slightly, may be nearing bottom. With a turnaround in demand, rates could "respond in a fashion that we haven't seen for some time."

Mr Mason says that the industry likely would not see the huge run up in rates experienced in 2001, but they should become firmer going forward. On the other hand, he also says that rates are not going to decline as much as in the past due to higher cost structure.

"Dayrates are not going to fall to levels that have been characteristic in the industry the past 15 years," Mr Mason said, "and the reason for that is the higher operating costs drilling contractors have today.

Ed Jacob, Senior Vice President of Operations for Grey Wolf Drilling agrees: "There was about a 20% increase in labor costs over this last cycle," he said. "Costs for supplies and maintenance items are also higher because the used equipment market has dried up."

"Used equipment could be purchase a couple of years ago for 10-40 cents on the dollar," Mr Jacob continued. "Today used equipment is unavailable."

"Labor has never been an insurmountable problem. Contractors have always found that if they pay enough money, the hands show up," Mr Mason said.

"In the downturn, however, we still have that higher base wage level so that plus replacement parts costs and rising insurance costs indicates to me that dayrates will not be able to fall as low as they have in the past."

In a recent report, Mr Mason said that workers' compensation and health benefits are expanding at double-digit percentage rates and could climb into the low double digit percentage of a rig's daily operating costs for smaller contractors, the first time this has occurred.

Mr Mason also says the market for maintenance, repair and replacement parts has been used up. In 1997, he says, a rotary table could have been replaced for under $5,000, and when spares gradually disappeared rebuilt rotary tables could be had for $10,000-$12,000. Today, he noted, rebuilt units are approaching $20,000. A commodity version of a 350-ton block would cost a driller $12,000 or less a couple of years ago, Mr Mason added. Now it is bought new at nearly $100,000.

Key Energy Services has rebuilt or refurbished more than 200 of its drilling and well service rigs since January 2000. The cost to refurbish a relatively small rig, one of Key's 350 series rigs, for example, according to Mr Richards is about $250,000 "crown to ground, where it literally is better than new."

That cost compares to approximately $750,000 to rig out a new similar size unit. With a pump and tank that cost is nearly doubled. That is a significant competitive advantage over companies that are going to try to build new rigs.

Mr Richards also notes that several other drilling contractors still have an inventory of good used equipment that can be refurbished which will result in an advantage going forward unless there are some great advances in technology that makes some of the other rigs much more attractive.

"When we talked about refurbishment," Mr Richards said, "we talked about restoring equipment to the original manufacturer's specification."

"Now it means going back with new power, typically new engines and new pumps and other new parts."

INTERNATIONAL MARKETS

International markets, although more dependent on oil prices rather than natural gas prices as a driver, generally are only marginally better than the US market, although there are a couple of active areas.

Salomon Smith Barney's international outlook is down slightly from last year with the company forecasting an average rig count of 730, down about 2% from 744 in 2001.

Salomon said it expects declines in Argentina and Venezuela and the Middle East with drilling activity in Europe, Africa and the Asia Pacific regions to be flat.

When Mr Smith talks about international markets, the first areas he mentions are offshore Trinidad and Brazil. There are a few projects in Colombia and Ecuador, he says, and there is potentially strong activity in Bolivia. Latin America is lagging behind the Middle East and Africa. Of the 108 rigs Nabors operates in the Middle East and Latin America, only around 60 are working.

"The rest of the international markets are fairly anemic," Mr Smith said, "and they are fairly competitive with smaller rigs and lower margins."

Key Energy Services has 36 rigs presently in Argentina, including nine drilling rigs and 27 well servicing units, Mr Richards said. He agrees with Mr Smith about the Latin American market.

"Obviously Argentina is slow," he said. "When you go through several presidents in one year you tend to have a slowing situation. If the political situation stabilizes there, we still believe in that market." ■