White knuckle markets promise opportunity, risks

John Kennedy, Contributing Editor

"OIL DEMAND FUNDAMENTALS are the best they have been in 30 years."

That assessment stood out in the comments made by a panel of energy industry analysts at the 2000 IADC Annual Meeting 27-29 Sept in Houston.

A lack of supply growth is the cause of the current supply/demand imbalance, rather than weak demand, said **Arvind Sanger**, Equity Research Analyst, **Donaldson Lufkin & Jenrette**. That provides a stronger underpinning for continued strength in prices and activity.

Producers also have good cash flow but have seen their production decline, so they are likely to begin spending on exploration and development.

"How much supply response do we get with, say, 800 rigs drilling?" If there is not adequate supply response, what should happen next? What other action should be taken?"

—Arvind Sanger

Donaldson Lufkin & Jenrette

Mr Sanger expects spending increases of 15-20% in 2000 and 2001 and the potential for significantly increased earnings among producers.

Arvind Sanger

And he echoed other speakers at the conference in saying that consolidation is not over.

Offsetting the supply/demand positives are some risks.

If prices are too strong, there will be both a supply and a demand response, according to Mr Sanger, bringing on more production and dampening demand.

Also, valuations are "rather full" and prices are at the higher end of the trading range.

UNDERSTANDING THIS CYCLE

"This cycle is supply shortfall driven," said Mr Sanger.

"Demand is a less-solid underpinning of the market, so this supply tightness gives us some comfort that we won't see a collapse in prices like that of the last cycle.

"This cycle could last 10 years," he said.

To help understand this market cycle, Mr. Sanger described its several stages.

Stage 1, commodity price recovery, occurred when crude oil prices moved above \$18/bbl. In the second quarter of 1999, the recovery in the North American rig count was the next stage of the cycle. Earnings recovery began in the fourth quarter of 1999; in the first half of 2000, the international and deepwater drilling markets were recovering.

Now in the second half of this year, the marine construction, seismic activity, and low-end deepwater work is improving.

Finally, Mr Sanger sees a recovery in the rig equipment and rig building segments in 2001 or beyond.

"There is a big rig building boom coming," he said.

Speaking to widespread concern about the industry's ability to meet robust growth in natural gas demand in the next decade, Mr Sanger said gas well drilling will rise to the levels needed to grow production.

But it is difficult to know exactly what that level is.

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As these questions are answered, "the next 12 months will be very interesting," said Mr Sanger.

The worldwide count of rigs drilling for oil is still too low to increase production, he believes. And he doesn't expect a large increase in non-OPEC production in 2001.

But oil drilling in the US will rise in the next several quarters, he said.

As more drilling is done with fewer rigs, Mr Sanger expects the earnings performance of service companies to be less cyclical.

Also, "more rigs in deepwater and fewer in West Texas means contractor returns will be higher."

Consolidation in the service and drilling sectors has been dramatic and will continue.

In most major service markets, the three big service companies have about 90% of the market he said. "The same will happen in drilling."

Looking at utilization, Mr Sanger said the Gulf of Mexico jackup market led the recovery and jackup utilization now is around 90%. Pricing is getting close to replacement levels and there may be some replacement if the market stays firm.

The international jackup market is also well along on the recovery path.

In deep water, the "high end" rigs led the way to recovery, but Mr Sanger expects the low end units to follow in the coming months.

BALANCED OIL MARKET

"We are in the first truly balanced oil market" in a long time, according to **Marshall Adkins**, Managing Director-Energy Equity Research, **Raymond James & Associates**.

He told Annual Meeting attendees that natural gas will drive the US drilling business in the coming years.

To meet the expected demand for gas drilling will require that the US rig fleet double in the next 5-7 years.

Noting that growing energy demand has made oil, gas, and electricity supplies all tight he sees several problems on the supply side.

First, global excess producing capacity is at an all time low; the cushion could be as little as 1 million b/d by the end of this year, he said.

Even if the supply is available, it may not be possible to get the oil to market. Tanker rates increased three-fold in the past 12 months, a strong indication that shipping capacity is also very low. And there won't be a significant net addition to tanker capacity in the next 12 months.

Marshall Adkins

Finally, even if oil production can be increased and tanker capacity is available, the crude can't be made into products if it did reach the US because refineries are currently running at full capacity.

What will happen?

In this precariously balanced market, Mr Adkins says market volatility will increase; average prices will be higher; and economic growth will be dampened. Prices will rise to a level that causes the marginal consumers to leave the market. These responses to the tight supply/ demand situation will eventually solve the problem, he said.

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Raymond James & Associates

In the meantime, however, "a supply disruption could be disastrous." Little new OPEC oil will be available in the next 12-18 months, said Mr Adkins, so prices will rise enough to bring demand back in line with supply. He expects an oil price of $32.50 in 2001.

"The gas problem will persist for years," said Mr Adkins. US gas production is bottoming now and all rigs are working.

From current consumption of about 60 bcfd, demand could rise 9 bcfd in the next 3-4 years while supply increases by only 3-4 bcfd. This would leave a supply imbalance of 5 bcfd for 3-5 years.

"In the short term, higher prices will crimp demand" to restore balance, said Mr Adkins. In the longer term, he expects to see significant growth in LNG imports to the US; very little is being imported currently.

A pipeline to bring gas from Alaska and the Canadian Arctic could also help provide long-term relief.

MORE RIGS A KEY

"We are now into a serious energy crisis and solving it will take a long time," said **Matthew R Simmons,** President, **Simmons & Company International**. "Utter tightness is just around the corner" said Mr Simmons.

Matthew R Simmons

He told the 2000 IADC Annual Meeting audience that solving this crisis will "fall on the back of the contract drilling business worldwide."

In 2000, "most drilling assets are old" and "so are the people," he said. "But hydrocarbons still underpin both the old and the new economies."

By the end of this year, he said, the new rig building era will be over.

Bottlenecks that face the contract drilling business in the years ahead involve people, capital, and the fragmentation of the market.

Looking ahead to the period 2007-2010, he forecast that at that time, the world would still need 450 offshore rigs and Texas alone would need an additional 700-2,000 rigs.

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—Matthew R Simmons

Simmons & Company

PRODUCTION DECLINES

Henry Groppe, Partner, **Groppe Long & Littell**, told the 2000 IADC Annual Meeting attendees that non-OPEC production either peaked in 1998 or is peaking this year. "Then it will begin a long decline," he said.

Henry Groppe

"After many years of low priced oil and high consumption rates, the world is out of oil and North America is out of gas," said Mr Groppe.

In recent years, exploitation cycles have been dramatically compressed, boosting decline rates. He forecasts "a long term, irreversible decline in production."

Two events will occur this year for the first time in the natural gas business, he said. There will be a real deliverability shortage, and virtually all new electric power projects will be fueled by natural gas.

"There will be a real natural gas deliverability shortage (this year)."

—Henry Groppe

Groppe Long & Littell

LNG will play a "major role" in bringing down gas prices in the US, said Mr Groppe, but the impact of significantly higher LNG imports is "several years ahead."