Deepwater success results in higher drilling activity

JOHN O'LEARY, VICE President, Worldwide Marketing for **Pride International**, says there is significant potential in deepwater exploration, which in some areas has evolved from the exploration to the development phase.

Competition in the contract drilling business will continue to be fierce and operators will continue to look for ways to drill cheaper and faster.

Near term opportunities will require a strategic approach toward selection of geographical areas and operator type such as major or state companies. The bottom line is that the market will continue to evolve and the winners will be those who anticipate trends.

INDUSTRY CHALLENGES

Speaking at the 2003 IADC Annual Meeting in Houston, Mr O'Leary said over the medium term the industry has to meet expanding energy demand and to maintain supply security.

Long-term challenges are quite different, Mr O'Leary says, and include reducing the impact on the planet and people and also realizing new energy possibilities.

"It is fair to say that we are on a trend curve that fossil fuels are exhaustible," he said.

From an economical viewpoint, the world economy seems to be regaining some momentum. The demand for energy is influenced by and large by what is happening in China. The US, on the other hand, is struggling to get back on its feet.

From a political standpoint, many of the major oil producing countries are politically unstable, he said.

Saudi Arabia is beginning to realize that it has terrorist problems, the future of Iraq is uncertain, and the industry hasn't seen the end of repercussions from the recent strike in Venezuela.

OIL SITUATION

OPEC now controls about 40% of the daily oil production and 78% of the world's oil reserves, Mr O'Leary said.

"The organization is doing a remarkable job in managing its production," he said, "with actual production from OPEC running about 1 million barrels a day on average in excess of their quota system."

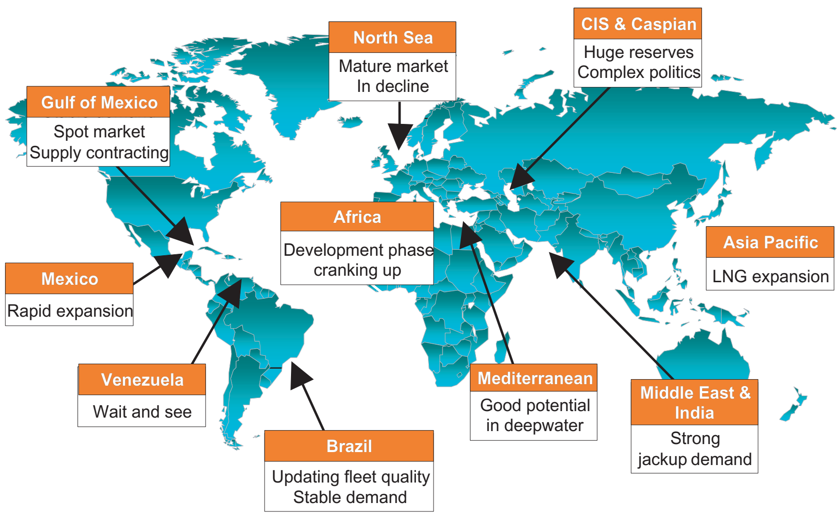
Mr O'Leary said OPEC has maintained stability with a price range of $20-$22 per barrel, and he expects that to go forward.

According to Shell, Mr O'Leary said, the industry needs another 80 million barrels per day of additional oil or oil equivalent to come onstream by 2010. A recent study by Wood MacKenzie puts the figure at 18 million barrels of additional oil by the year 2007. These are based on very conservative projections of 1.5% growth in demand per year coupled with 1.5% depletion from existing fields.

"These depletion figures may be conservative based on what we are seeing in the North Sea and the Gulf of Mexico," Mr O'Leary said.

More interesting for the drilling markets is the tightness of the oil market, he noted. The industry had about a 25% buffer in terms of productive capacity in the mid 1980s compared to about 5% today, meaning, he said, if there is a glitch on the supply chain side, then the industry faces a production or a delivery crisis.

Spotting The Trends



NATURAL GAS

A different spin from an offshore driller's standpoint is that much of the gas is concentrated in the Middle East and Russia, and Mr O'Leary believes energy imports into the US will become a reality over time.

"I don't suspect that these sources would supply more than 10% of the market," he said, "and this would not happen prior to 2008 or 2009."

In order to deliver gas to the US it has to be imported from somewhere, and LNG carriers are being built presently, about 58 of them, Mr O'Leary said, which means that many of these are being built on a speculative basis.

"That means that we will have a spot market very similar to the oil business," he noted.

OFFSHORE RIG FLEET

The offshore rig fleet currently includes 670 rigs, of which 60% are jackups and 30% are floaters with the balance being barges, tenders and submersibles.

The utilization rate of all rigs stands at a dismal 72% today, although some rig types are 100% utilized in certain areas of the world.

"This is dismal compared to what we

had in the second half of 1998 when utilization was 85% plus," Mr O'Leary said. "There is a lot of upside potential here."

The market is pretty flat presently, he said, with more or less at a constant number of rigs, with newbuilds matching attrition.

On the supply side rigs are being concentrated into fewer owners. Of the 93 rig owners, the top 10 now control two-thirds of all offshore rigs, Mr O'Leary said. The next 83 companies own the remaining one-third, basically 230 rigs.

"We have had significant consolidation but we still have fragmentation in the industry," he said.

The story is well known on the demand side of the equation. From 41 oil and gas companies in 1997 the industry has consolidated into 11 in 2003, he noted.

"I don't believe for a minute that this has produced any additional activity for the drilling contractors," Mr O'Leary said. "I don't have any hard evidence to say the contrary, either."

"But I believe that the focus of many of these companies has been on managing the merger and acquisition activities over the last few years and not focusing on E&P activity."

E&P COMPANIES

Today, Mr O'Leary noted, 36% of all rigs working are contracted by state oil companies directly. They have their own rigs and they contract third party rigs.

This percentage has grown in recent years and is expected to continue to grow.

Additionally, the importance of state oil companies is further underlined in places like Malaysia or Nigeria where national oil companies have the right to veto or the right of approval in the terms or the choice of rigs that are being contracted by the concessionaires, he explained.

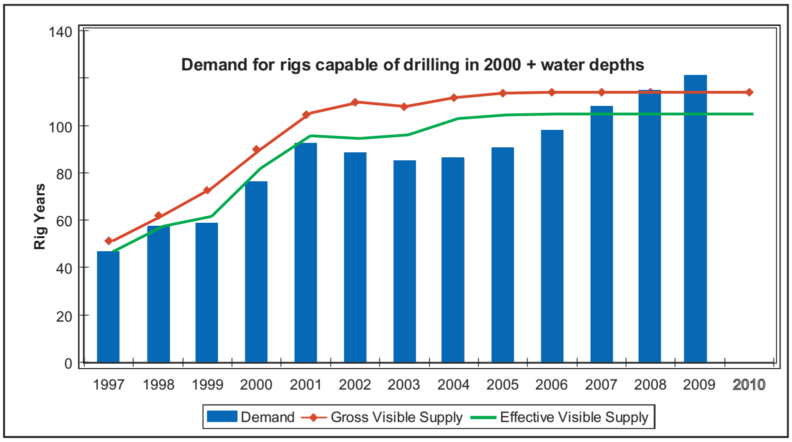
State companies are quite important from a driller's standpoint. The drivers for the state oil companies are primarily foreign currency earnings, or perhaps energy self sufficiency. This results generally in longer term contracts.

The average duration of a contract given out by a state oil company today is 1,156 days, according to Mr O'Leary, while the average duration for an offshore unit for an independent company is about one year.

The drivers for the majors is basically Wall Street pressure for return on capital, production and observed growth, although the latter seems to be moving off the radar screen a little bit, he said. Security of supply and the need to feed their downstream business are other important drivers.

As far as the independents are concerned, Mr O'Leary said, especially the smaller independents, it is making money as their activity is driven by the cash flow cycles.

Worldwide Deepwater Rig Demand



Source: ODS Petrodata Deepwater Rig Market Report

AREA TRENDS

The jackup market in the Gulf of Mexico has shown some improvement on pricing recently, however this is primarily due not so much to an increase in demand as in decreasing supply. Many of the rigs have mobilized for contracts offshore Mexico. Pride has sent 30 rigs to Mexico in the last 12 months, Mr O'Leary commented.

"There has been rapid expansion in Mexico," he said, "and according to the latest projections we expect that there will be another 10-12 jackups in the next 12 months."

In other areas, Mr O'Leary said that the industry is in the wait and see mode regarding Venezuela. In Brazil, Petrobras is utilizing this period to change out older equipment with more modern rigs, which is happening in a systematic manner. The North Sea is mature. "I don't believe for a minute that the entrance of the smaller independents will increase (drilling activity) in any significant way."

West Africa is probably the rosiest market of all, he said. The industry has come from a prolific exploration phase to now a development and exploration phase where many of the better rigs will be tied up for term contracts over the next 2-5 years.

There is potential also offshore Egypt in the Mediterranean. Strong jackup demand in the Middle East and India is driven by self sufficiency projections and by massive reserves of gas both in Iran and Qatar.

In Southeast Asia, the market is structurally oversupplied in terms of floaters but there is potential for the jackup market.

Some huge reserves in the Caspian Sea have been found, many of which are in shallow waters being drilled by land rigs that are transported and put on barge units. This will give rise to some demand, Mr O'Leary said.

ACTIVITY INDICATORS

Onshore drilling in the US has been a good indicator of offshore activity, Mr O'Leary noted, however, this may be changing. There is a disconnect beginning in January of this year with land rig activity increasing while rig activity in the Gulf of Mexico is basically flat.

The increase in gas price has not impacted the market for several reasons given by the industry, including lack of prospects, which Mr O'Leary said will be corrected, and lack of capital availability as operators focus on their balance sheets.

"It may be this lag is just a little bit longer than usual," he said. "Cash flow is being reduced by the balance sheet and high prices may not last."

"Finally some companies believe it may be cheaper or less risky to buy reserves rather than explore for them," he continued. "Of course, this is not going to produce any additional reserves."

"There will come a time when the reserves that are required will have to be produced, and that takes drilling rigs."

DEEPWATER

Deepwater reserves, anything in excess of 500 meters, have increased 35% over the last two years, Mr O'Leary stated, with deepwater reserves now at 80 billion barrels of oil.

Even more interesting, he said, is the global triangle of the Gulf of Mexico, Brazil and West Africa. West Africa has 50% more proven reserves than each of the other two areas, despite the fact that deepwater exploration and development commenced much later in West Africa.

Deepwater exploration successes resulted in increased drilling activity. In 2001 the industry drilled about 200 deepwater wells, 10 times more than just a decade earlier.

As deepwater activity has increased the industry is seeing a reduction in the number of reserves added on a per well basis. This doesn't mean the industry is in a mature market but that many of the large or easy to find reservoirs have been found first.

Development trends are moving into deeper and deeper water as well. Over the next five years the industry will see many development projects in water depths between 1,000 and 1,300 meters.

"Notwithstanding that we are going deeper, the current industry standard for development cost is reducing," Mr O'Leary said. "Many of these development projects are producing oil at less than $4 per barrel."

TECHNOLOGY

Mr O'Leary questions whether new technology is a threat or an opportunity to drilling contractors, and he admits he doesn't necessarily have the answers.

He asks if increased use of surface BOPs, lighter risers and moorings and artificial seabeds mean higher dayrates for second and third generation semisubmersibles, or lower dayrates for fourth and fifth generation units?

If wells can be drilled faster and cheaper, will the result be more wells drilled, or simply less rig usage and lower dayrates?

Finally, he wonders, will faster well construction from dual derricks bring correspondingly higher dayrates?