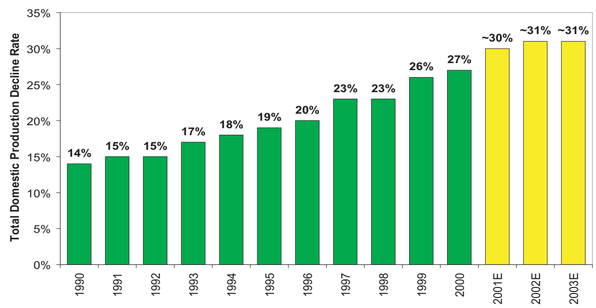
Industry is in a multi-year cycle of improvement

Natural Gas Production Decline



Source: Petroleum Information/Dwights LLC, BAS LLC

JAMES K WICKLUND, Managing Director, Oilfield Services Research for **Banc of America Securities LLC**, has a positive outlook on the oil and gas industry, for drilling contractors and for service companies. He believes the industry is presently in a multi-year cyclical period of improvement, but he also reminds that there is nothing that can stop a cyclical industry from being cyclical.

Mr Wicklund also believes that the rig count in 2004 may peak and then rollover but international activity will remain strong. This will help the contract drilling industry but he warns that investors only seem to care what happens to the US level of drilling activity, so stock prices are likely to decline.

Mr Wicklund, speaking at the 2003 IADC Annual Meeting in September, said the long-term outlook for the industry is positive. However, he said, both crude and natural gas will have long-term supply and demand problems as production continues to decline and demand is expected to remain flat or increase only slightly.

The short-term outlook is more problematic, being dependent upon near-term changes in commodity prices, with crude oil price often held hostage to politics. There are presently few companies to add capacity in the face of near-term uncertainty.

"The fear perception still exists," Mr Wicklund said.

"The E&P companies may not spend all of the money they generated this year," he said, "and you never know what OPEC is going to do."

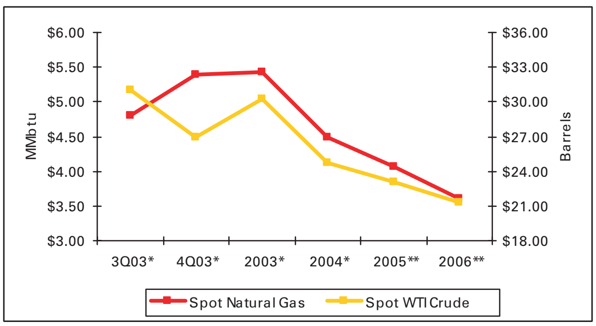
"No one has any confidence in the visibility or continuity right now of the drilling business," he added.

However, he said the US is doing better, with the expectation that natural gas demand will be up 1% and gross domestic product (GDP) will probably be up around 3%.

Weather will play its usual role.

"Analysts say every year that weather doesn't matter and then from the middle of September to the end of December, all that matters to them is the weather," Mr Wicklund said.

Commodity Price Forecast



"We are at the point now where if we have a cold or average winter we are golden," he said, "but if we have a warm winter we are in trouble."

With the expectation of $20 oil and $3 gas, he said, and the expectation that weather could be warm, then natural gas storage could become full and prices would crash.

LNG HELPS MEET DEMAND

The US is the most efficient gas producer in the world, Mr Wicklund said, so the likelihood of dramatic increases in domestic gas production is going to be difficult.

However, he added, the present natural gas supply and demand scenario is interesting. What drives the positive cycles is if demand is going up and supply is coming down.

The industry is facing the situation today, however, where demand is going down a bit and supply is going down a bit, yet the industry can't meet the demand.

Liquified natural gas could help that situation.

"We have done work showing that in six years if LNG represents 10% of gas consumption in the US and we only have ½% annual demand growth, then the rig count in six years will have to be 30% higher than it is now."

"The idea that LNG is going to kill your business isn't right," he explained, "it's a positive. The long term outlook for increased drilling activity exists."

LNG is not expected to materially increase for another 3-5 years and Canadian imports are expected to decline in the near-term. The result is that the bulk of US natural gas supply is still expected to come from US production.

GAS RIG COUNT INCREASE

Natural gas drilling should continue to increase on a long term secular basis, Mr Wicklund believes.

"We think that the rig count will be up 15% next year in the US," he said. "That will occur even with lower commodity prices."

E&P EXPENDITURES

Historically, he said, E&P companies spend 85-90% of their cash flow. This year he expects they will spend 60-65% of their cash flow.

"They are paying down debt," Mr Wicklund said, "but they finished paying down the debt as much as they needed to several quarters ago."

Next year, Mr Wicklund believes, the independent E&P companies will spend

80-85% of their cash flow plus spend money they have left over this year. He also said the independents will buy properties from the majors.

"They will do what they always do when they buy properties from majors," he said. "They will drill them. There won't be as much concern over the lack of quality drilling prospects. It's amazing what a half price (lease) will do to generate more quality drilling prospects."

"When you see the forecasts and surveys by analysts that spending will be up by 6-8%, the deck is stacked against them by the questions that they ask," Mr Wicklund noted. "A year ago when they came out and said spending this year was going to be up 3-5% and then the rig count was up 24%, the surveys were wrong."

"So don't pay much attention to the surveys that say spending will be up 4-5%," he continued. "We think it will be closer to 15%."

HIGHER DRILLING ACTIVITY

Mr Wicklund believes that drilling activity will be up next year and be seasonable, and that it will probably peak in the fourth quarter. He said the rig count will probably decline in 2005. The bottom of the rig count in the 1998 down cycle was below 500. In the 2001 down cycle the US rig count went down to 700, he noted.

"It may very well be that in the next down cycle the rig count won't go any lower than 900 to 950."

"That is like dreaming of $4 gas," he said, "but here we are with $4 gas and it is not quite what we dreamed."

"Rig activity will rollover, it will stay up there, but even with a 950 rig bottom it won't feel quite as good as the rig count was expected to feel. It will be a little disappointing because it won't feel quite as good as it was supposed to be."

The cycles are getting longer, Mr Wicklund said. Over the last eight cycles, back to the mid 1970s, the average up cycle lasted for 22-28 months. However, the argument now being fostered by investors is that the present cycle is going to last five years.

"The industry can appreciate that over eight cycles the average was 22-28 months but this time it will be 60."

"But it is different this time," Mr Wicklund concluded, "and that is also why whenever you make that statement people give you a great deal of abuse."

The natural gas supply and demand story points to only one ending, Mr Wicklund believes, and that is a shortage of gas. Additional rig activity is necessary just to keep the production rate flat, so rig activity could see higher highs in the future.

The bottom line, he said, is falling supply plus flat or improving demand plus less production per rig means the need for more rigs drilling over time. ■