

Worldwide Deepwater Drilling Activity: Can the Industry Experience Rational Growth in This "Age of Prosperity?"

by Scott B. Gill,
Simmons and Company International

The worldwide deepwater business, like the rest of our industry, is at a critical juncture. The opportunities for the industry are huge. Projecting a 15% annual increase in the amount of worldwide exploration and production spending for five years, the oil service industry will need another \$96 billion in capital over a five-year period. How can we grow this industry? Can the industry experience rational growth or does the industry continue to experience volatile ups and downs?

Hydrocarbon demand is at an all time high and is increasing at a rate of 3% per year. The industry must now not only supply the world's insatiable appetite for more hydrocarbons, but must overcome its own nemesis—depletion. First-year depletion rates for natural gas production have risen from 26% in 1991 to 46% in 1996. The industry must replace the ever increasing amounts of the prior year's production and then add more supply to meet the incremental demand.

In the midst of true growth for the commodities of oil and gas, our industry has changed from one of chronic excess capacity to one of chronic shortages. Today, supply must come from one source: more drilling. Offshore is the most effective near-term frontier area to which the industry can turn in order to supply the world with the oil and gas it demands, and the deepwater sector contains the most prolific reserve and production potential. The problem (or the opportunity) is: we are out of rigs, we are out of equipment, and we are out of people.

450 More Rigs Needed Worldwide

Until two years ago, the excess supply of offshore rigs had been around for so long that it seemed almost impossible that we could experience a rig shortage again. Today 33 oil rigs are under construction, but the cost for today's rig is 30% higher than it used to be. The pinch of rig shortages and the resulting impact it will have on project delays and missed production targets are just beginning to be felt. We believe that 450 more offshore rigs will be needed to return the E&P business to rig equilibrium. In Canada, there might be a need for 250 to 300 additional rigs to merely supply the daily gas volume needed to fill the pipelines being added to bring more Canadian gas to the U.S.

Conservative estimates assume that offshore production will grow only 2.3%



The offshore drilling industry is short of rigs and people according to Simmons International Vice President Scott Gill.

annually through 2007. Conservative growth rate indicates that an additional 90 offshore rigs are needed to do development and workovers. An additional 60 rigs will be needed to drill at 100% utilization for 10 straight years to put one well on each Gulf of Mexico lease in over 3,000' of water.

During the peak period of offshore exploration in the mid-1980s, 388 rigs were drilling exploratory wells around the world. This compares to about 200 today. In 2007, the exploratory fleet should be back up to the mid-1980's level and 188 additional rigs will be needed.

Rig Costs: A Challenge

Rig construction costs are not static. We have already seen costs escalate over 30% in the past two years. During the last construction cycle, construction costs rose 15% to 22% per year. The bottom line is that day rates for drilling rigs must go up!

How can we possibly expand when there seems to be a stalemate between the rig contractors who are unwilling to build new rigs and E&P companies who do not seem anxious to pay higher day rates?

Today's day rates do not justify a return in excess of the cost of capital for new rig construction. Most of the contracts signed this year will barely break even. New construction costs on a semi-submersible rig are estimated at \$300 million with delivery scheduled for 36 months in the future. A five-year contract at a day rate of \$200,000/day does not provide the economics to justify its construction. Who would build a \$300 million asset that reaches break even when the business up-cycle may be over?

A 10 Year Need for 71 MMBOE Per Day

There will be a 10 year need for an incremental 71 MMBOE per day. If the industry has any hope of meeting this goal then there has to be a lot more drilling. The capacity overhangs from 10 years ago have long since eroded. Gone is the 20

MMBOE per day excess oil capacity, gas bubble, and the 450 excess offshore rigs of the past. The land rig market is nearing 90% utilization rates. The industry must face the stark reality that the bubble era is over. With the bubbles of the prior decade gone, the only means by which we can meet the hydrocarbon demands of the next decade is to drill.

This "Age of Prosperity" is most seductive and its opportunities enormous. Its lure will also bring this cycle to a halt one day. Oversupply will happen as it always does. Yet, we are in the beginning of a long up-cycle. To grow rationally, the industry must get back to drilling. The industry must focus on getting more production and reserve recovery from its existing fields. The industry must continue to look for and explore future reserves like those in the deepwater Gulf of Mexico. The industry also needs more equipment, and most importantly, more people.

BIOGRAPHICAL SKETCH

Scott Gill is currently vice president with Simmons and Company International. Gill has a B.S. in mechanical engineering from Louisiana State (1981), and worked for Amoco Production Company in the Gulf of Mexico operations. While at Amoco, Scott worked in several engineering capacities, and managed their Gulf of Mexico production engineering group. Gill served as director of Integrated Solutions for the newly formed Baker Hughes INTEQ division. He is a registered petroleum engineer and holds a M.S. in business administration from Tulane University.

Please make reservations by Feb. 6th—reservation code 5-0-1
