Hitting the Reset Button

The Texas (and U.S.) Oil and Natural Gas Industry

By Alan Lammey

In the last several months, Texans who make their living from black gold and natural gas have helplessly watched as the New York Mercantile Exchange (NYMEX) traded prompt-month oil and natural gas futures prices that cascaded to lows not seen in well over a decade. For the oil and gas industry as a whole, this price downturn has only exacerbated an already enormous amount of financial pain that has been inflicted on Texas oil and natural gas producers in recent years and throughout nearly all of 2015. Without much light at the end of the tunnel for a potentially extended period of time from the supply and demand, weather, and a technical price perspective, these grave circumstances beg the question, "What will be the industry's reset button to remedy *this situation*?"

As of mid-January, West Texas Intermediate (WTI) oil futures fell in the mid-$20s per barrel, marking the lowest price since 2003. Natural gas futures were wobbling near the $2 per million British thermal unit (MMBtu) or lower. What makes this particular price downturn so remarkable is that it isn't occurring during a seasonal period of time when energy demand is down. For natural gas, it's happening during a time of the year when gas prices historically hit their uppermost peaks.

Last year, during the January and February time period, WTI prices were hovering near $50.00 per barrel, while natural gas futures prices were ranging between $3.50 and $4. Interestingly enough, over the course of this past June and August, WTI was trading near $60, and gas futures prices were trading frequently in the $2.80 to $3 area. While these were thought to be "too low" at the time, there were several large U.S. oil and natural gas producers mentioning their intention to wait until this winter to begin hedging some of their production at seasonally higher prices on their quarterly earnings calls. Unfortunately, this strategy has seriously back-fired due to nearly unprecedented warmth in the eastern half of the nation.

In this day and age, the term *reset button* has become a widely known expression of how an unsolvable situation can be quickly and effectively remedied to stop a major problem in its tracks. Typically, reset buttons work quite well, restoring both function and stress levels back to normal. Most participants in the gas industry would probably agree that it would be nice if the North American natural gas industry, which is in a tailspin of oversupply, could just press a reset button too.

This Reset Button Isn't a Pretty One

However, this reset wouldn't be a nice one. The critical reset button for an industry that keeps drilling for more and more natural gas with little economic rationale results in an exceedingly steep and painful drop in gas prices. However, that button may be pressed sometime in 2016. It's been repeated in the news media for many months that unless something major emerges to turn this situation around, a rash of bankruptcies may be looming in the not-so-distant future.

With gas futures prices now trading at near historic lows, it goes without saying that some of the largest (and smallest) gas producer companies in the market are currently struggling to keep their heads above water. For example, Chesapeake Energy (CHK), which is the second biggest natural gas producer in the U.S. as well as the producer of a respectable amount of oil, has recently seen its stock share price plummet below $3 per share for the first time in the history of the company. This could threaten its listing status on the New York Stock Exchange (NYSE) since the minimum share price for NYSE listing is $5 per share.

In fact, retired veteran natural gas hedge fund mogul of Centaurus Capital, John Arnold, commented via Twitter in early December that the threat of bankruptcies may be coming closer to a reality: "With few hedges for '16, half of the U.S. energy industry will be bankrupt in six months with prices at these levels. OPEC definitely smells blood."

How Did the Industry Get Here?

So how did the oil and gas market get to such a painful place, and how low can prices go from current levels if winter demand in the eastern half of the U.S. only makes a minor (or even normal) showing in January and February?

While there are multiple foreign oil producers (OPEC) drivers to currently low energy prices, the fact is domestic oil and natural gas production skyrocketed in recent years. It's no secret that more than abundant supply drives prices down, which has been the case for most of the past few years when production from shale oil and gas wells has overwhelmed the usual drawdown of gas inventories. Currently, the U.S. produces just over 9.3 million barrels of oil per days. Meanwhile, natural gas wellhead production has consistently hovered between about 81 billion cubic feet (bcf)/day and 83 bcf/day each week for most of 2015. These are record highs that are extraordinarily robust considering the immensely bearish state of affairs at hand for the industry, but a chief reason behind why oil and gas supply is so overwhelmingly dominate is fairly eye-opening by itself. Ever since the gold rush to shale production via fracking ramped-up around 2008, the utilization of massive credit and resultant mountains of debt toward an onslaught of production projects has created the mother of all negative price loops for the industry.

In order for oil and gas producers to presently service giant debt loads in a declining price environment means more revenue is required. About the only way for energy producers to boost revenue is to increase drilling and produce even more molecules in an already supply-glutted market. This, in turn, steadily decreases prices while also devaluing underground reserves. Unfortunately, the now-lower prices don't generate enough revenue to pay the bills; therefore, even greater production efforts are required, even if it means collecting outrageously low prices for the oil and gas commodities. Because prices are trading at such historically low levels, virtually no producer companies are hedged. It doesn't take long to see how this sort of negative-loop can turn into an all-out industry death-spiral for some companies, especially in light of the fact that banks and investment companies are, by and large, no longer lending to the oil and gas industry at this time.

No Loans for Oil and Gas Producers

"When a producer isn't hedged, it complicates the matter in terms of security on loans. Therefore, new projects and completion projects will eventually slow due to the limited availability of credit capital resources," said Ray Pereira, Houston investment banker. "And in fact, many investment firms are not making any new loans at all and are only maintaining what they already have."

In addition to daily production of oil and gas, prices are very sensitive to how much supply is available in U.S. storage facilities. At this juncture, U.S. oil inventories are sitting on 80-year high oil supplies. For natural gas prices, the storage situation became acute as of this past November when injection season totals topped 4 trillion cubic feet (Tcf), marking new, all-time record highs for gas storage inventories. As the gas industry entered the fall, one of its only saving graces was going to be this current winter. However, those who were hoping that a cold winter would burn off excess gas supply and ease the situation have become sorely disappointed.

The month of December from a weather demand perspective was considered to be the pivot point or make or break catalyst for gas futures prices. With an unusually warm December and most of January, especially for the eastern half of the U.S., now it's up to February and March to keep energy producers on life support. But when it's down to only one or two winter months before warmer climatology begins to set in for the spring, even a bitterly cold situation will more than likely be insufficient to draw down oil and natural gas storage inventories to low enough levels to mitigate conditions where a rapid gas storage refill would occur. And refill season begins at the end of March 2016.

In fact, the proverbial reset button may be reserved for the spring or early summer of 2016, when significant levels of surplus storage emerge in advance of the summer cooling season. At this juncture, natural gas storage volumes in April, which is one of the lowest demand months of the calendar year, are already projected to be significantly higher than what is considered normal. Unless February and March winter temperatures come in with an anomalous vengeance, the overall supply and demand equation will continue to be hugely weighted to the supply side. This may set into motion a further decline in energy prices in the months to come.

Repeated Reset

Then how long it will take before unreasonably low oil and natural gas prices will entice real shut-ins of well production? There are definitely some big, gut-wrenching factors at play for the industry, including several billion investment dollars at stake that are attempting to operate in notably sub-economic conditions, not to mention potential complications with land retention issues. With oil trading in the $20s and natural gas prices at or under $2 per MMBtu, cash flows for many U.S. oil and gas producer companies will go critically negative at some point. This may trigger a big reset button in a flurry of bankruptcies as a last resort. If the big reset button doesn't work the first time, the button may have to be pressed several more times, each time a little harder than before, until some meaningful equilibrium between supply and demand is finally restored.

In terms of projecting how low oil and gas futures prices might go, one only has to look at the past. Historical pricing shows that there are multiple prompt month prices reference points that need to be considered. For oil, WTI prices have a real potential of testing the low $20/barrel area before bargain seekers begin buying in earnest again. For natural gas prices, the last time winter natural gas futures contracts traded below $2 was in December of 1998, when prices oscillated between $1.71 and $2.11. Following the already stated $1.902 in 2012, then came $1.85 in January of 2002. Below this price area, next in line was $1.76 in July 2001, while $1.62 was seen in January of 1999. Lastly, the lowest prompt-month futures price was $1.25 during early January of 1995.

Presently, while it's possible that very technically oversold conditions could support a bit of a near-term bounce in oil and gas futures, it appears that any rally will probably be faced with a bout of profit taking until the true underlying supply and demand symmetry is re-established by waning production. The one major wildcard for oil prices will be geopolitical in nature. Not only is the Texas economy largely based on oil and natural gas prices, but most of the globe is as well. When prices fall too low, it creates all kinds of incentives for unusual geopolitical events or happenings to occur that could send prices climbing again. **N**

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