Life after COVID-19: Independent Shale Oil Producers

BY ELEANOR MORRISON

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At the start of 2020, the United States triumphantly took over the title of the largest oil and gas producer in the world, at 13 million barrels per day, supported largely by unconventional production sources. This confirmed the impressive track record of independent shale oil producers, shown to be resilient to previous price collapse situations and continued to grow, under lower costs structures and higher operational efficiencies. Despite the production growth amid strong oil price dynamics providing profitable returns over the past few years, oil and gas equity performance has been under pressure. Analysts and investors have been monitoring the small to medium sized independent shale oil producers' performance, as questions remained on the survivability of the business model, as the production sector matured.

The impact of global governments' response to the coronavirus outbreak, parallel with the Saudi-Russian price war, caused a steep decline in oil prices. The rapidity and magnitude of this global demand shock has never been observed in modern day oil markets. Futures prices at the WTI benchmark for the May 2020 prompt contract fell to below ten dollars and briefly into first-time negative territory. With global storage facilities full and supply shut-ins lagging the extraordinary collapse in demand, these historically low prices are expected to remain in the short term. Once the pandemic subsides, the demand-supply equilibrium depends on the length and ultimate depth of the disruption to economic activity.

The timing of this global negative demand shock arrived as investors' faith in shale oil producer economics was tested. In response to plummeting global oil prices, U.S. fracking experienced a large decline between February 2020 to April 2020, currently running at 60% lower started fracturing operations since the start of the year[1]. Hurried shut-ins were in response to cancelled customer contracts and uneconomical market prices. In an environment with no new fracking wells coming to market, there could be up to three million barrels per day lower production by year end[2]. Restructuring advisors have been engaged in attempts to create survival trajectories for many small to medium sized independent producers. Low cost funding supported the recovery of shale oil producers after the 2014 price collapse, resulting in the current large debt positions on corporate balance sheets.

Independent shale oil producers have comprehensive derivative hedging programs to limit downside market risk exposure, usually mandated by loan covenants and implemented by risk managers. Producer oil price hedges are based on expected annual production in future years. At the start of the year, approximately 50% of the 2020 production was hedged and a significantly lesser volume for 2021 production[3]. Many of the hedge instruments used by shale producers are three-way collars, which provide a false sense of protection, in that under large price collapses the hedge is ineffective. To reduce the cost of hedging, many producers enter into this three-way collars strategy, which is the combination of a traditional collar, long put option and short call option, plus a short put option at a much lower out-of-the-money price level. Under a massive price collapse, producers are left without a floor protection, as was last observed in the 2014 low price event. Future risk management programs should limit the use of three-way collars, given the failed price protection observed in 2014 and again this year, and review the additional cost of upfront funding of standard collar hedging program.

The preference of investors for independent shale oil corporates was supported by wells offering faster returns, because of high initial production rates, compared to conventional oil producers. In the drive to grow and satisfy investors, shale oil operators have moved to costlier capital expenditure strategies, to develop superlateral well designs, which source oil faster with a lower unit cost. This trend is moving many producers from industrial turnkey operations, towards the traditional capital intensive driller structures, which further depletes their cash reserves.

The expected trajectory for global demand return is unknown and will probably not be uniform across all industrial sectors. Governments have yet to determine appropriate policies and timelines for the economy to enable societies to return to a business as usual operating environment. It will take time for the global oil storage glut to recede under a return of demand pattern and a new OPEC+ production policy. The independent shale oil producers, who successfully hedged and survived this price downturn, will be challenged to secure investor support, when profitable oil price economics return. This time, investors may not be as supportive of independent shale oil producers, who still have yet to demonstrate the expectation of a positive cash flow performance. Opportunistic acquisitions in key shale oil field locations, such as the Permian basin, or based on a corporate hedge book, will be expected once corporate valuations are deliberated. Shale oil production will eventually return to domestic supply channels, but under market consolidation.

Footnotes

1 U.S. Fracturing set for biggest monthly decline in history, Oil and Gas Journal, April 22, 2020.

2 Ibid.

3 U.S. shale companies hedges were inadequate for oil price crash, Devika Krishna Kumar and Liz Hampton, Reuters, March 13, 2020.