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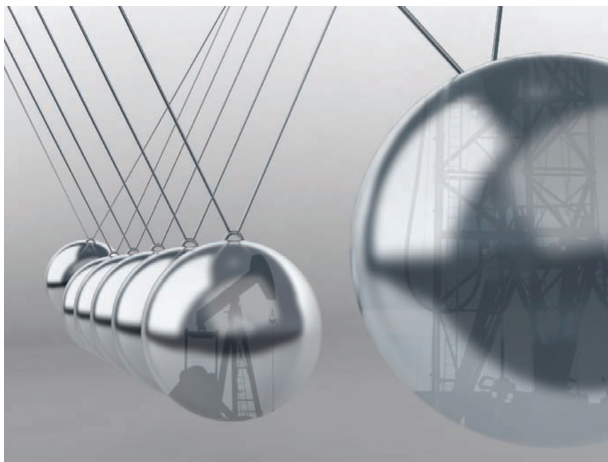
Economic, Political Trends Drive Market Reactions For 2010 And Beyond

By Gregory DL Morris
Special correspondent

Public investing, both debt and equity, is beginning to return to the independent upstream sector, according to investors and analysts. Bank lending and venture capital have yet to thaw, but lenders and market watchers say they expect that to accelerate in the wake of several high-profile transactions.



For instance, Denbury Resources reported in November that it had reached an agreement to acquire Encore Acquisition Company in a transaction valued at $4.5 billion. On the same day, Petroleum Development Corporation and Lime Rock Partners announced a joint venture company, PDC Mountaineer LLC, focused on the Marcellus Shale play. But the biggest was the Dec. 14 announcement that ExxonMobil had made an all-stock deal worth $31 billion to acquire independent gas producer XTO Energy.

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"The ExxonMobil-XTO deal was definitely a surprise," says Catherine Madden, senior research analyst with IDC Energy Insight based in Framingham, Ma. "One deal is not necessarily a game changer, but the power of ExxonMobil, and the strong corporate philosophy the company has, are definitely now a factor in the independent sector and unconventional plays. Other majors may say publicly that they do not have to follow suit, but privately they have to consider all their options."

Transaction Traction

Michael Bodino, co-head of research at Madison Williams and Company in Dallas, says he likes the ExxonMobil-XTO transaction for several strategic reasons. "I have known XTO for 16 years, since the company's initial public offering," he says. "XTO was the premier player in domestic exploration and production. ExxonMobil bought a great collection of assets. Operationally and financially, XTO is very proficient and has very low cost of capital."

Bodino adds that the deal represents the 11th largest U.S. natural gas producer buying the number one producer, but more importantly, the two companies also each ranked near the top of the list in terms of gas reserves. "With the combined reserves-to-production ratio, ExxonMobil has good, long-lived reserves," Bodino observes. "That means only a modest amount of capital is needed to maintain production, which means lots of free cash for other investments."

Analysts say the ExxonMobil-XTO deal and other year-end transactions do not necessarily mean private equity and bank lending will rush back into the independent sector. And no one is predicting a quick return to prerecession conditions. But changes are clearly under way, Bodino assures.

"Capital markets are open and deals are being done," Bodino remarks. "Banks are sitting on lots of cash. Private equity still needs banks to extend more credit, so for the moment, they are probably calling proven management teams, looking for whom to back. The other factor may be that some midsized independents may think they have to get a bit bigger to get noticed."

Tactically, analysts say they expect XTO will be kept largely intact as the core of a new unconventional resource division within Exxon. There is also a broad expectation that not all assets will be kept, adding impetus to a new round of balance sheets and asset portfolios being rationalized and sanitized. An early mover on the private equity side was David Keyte, who resigned as executive vice president and chief financial officer of Forest Oil Corp. on Dec. 1 to raise funds to acquire and exploit energy properties.

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Picking Up The Pieces

New interest, even enthusiasm, in the independent upstream sector does not change the overall economic situation after 18 months of recession, however. "The general impression I get from capital markets is a continued improvement of the situation as we have seen already, starting in April, May and June," says Bill Weidner, managing director at investment advisory firm Rodman & Renshaw. Weidner differentiates public capital–which includes institutional investors and mutual funds, but also public debt markets for the purposes of this distinction–from venture capital or other private sources of investment. "The public sector is hungry and very liquid," he notes. "But all of that enthusiasm is tempered by the apparent overhang in natural gas. That is not the case in oil."

The "oddball factor," Weidner adds, is that the public markets love unconventional resource plays, some of which are not viable at current gas prices, he notes. While Weidner is not willing to hazard a guess as to when supply and demand fundamentals may swing back into balance to lift gas prices, he does note that low prices eventually stimulate demand. "However, in the near term, the market can stay irrational longer that a company can stay solvent," he cautions.

Several market watchers have observed that, in contrast to natural gas, crude oil has become an international currency. "With the debasement of the U.S. dollar, oil has become a comfortable place to go," Weidner observes. "Gold is the traditional inflation hedge, but gold does not give much of a return. Oil is the gold that has a return."

The inflation hedge argument did not exist three or four years ago, Weidner explains. "We polled institutional investors, and at that time, none said inflation was a significant factor in the price of oil. Today, if we repeated that poll, a lot would say it is a significant factor."

On either the oil or gas side, Weidner says, "There is new capital available both from new debt or new equity. Some small- to midcap players have issued both."

He adds that while operators have been lauded for their success in raising equity capital, it has not come without significant dilution for pre-existing shareholders.

Bodino explains a run-up in independents' stock prices in recent months, observing, "A few investors moved on what they thought were compelling opportunities, and others jumped in because they did not want to miss the boat. We exhausted the sellers at the end of last year and now access to public capital has resumed. Bank financing, however, is only now beginning to come back into the market in any meaningful way. That has not been an oil and gas problem, but a banking industry problem. Banks continue to wait for credit quality of oil and gas

companies to improve, and access to public debt and equity is helping."

Not Playing The Tune

Venture capital is playing coy, in Weidner's assessment. "The common refrain is that they are not putting out any overhead money for producers any more. We had a great run for the better part of nine years with venture capital backing management teams, but that music has stopped," he states.

That does not mean, however, that private money is out of oil and gas for good. "For operators who have a track record of expertise and success, venture capital will come around when prices recover," Weidner insists. "The key is that the model has to be repeatable and scalable. Access to market for the commodity is also a key factor."

The going rate today for oil assets, says Bodino, is about $75,000 per flowing barrel. "You can find cases where people have paid higher if the assets clearly have running room. Sometimes people have paid less. That is mostly for assets, not for whole companies," he remarks.

Historical patterns from previous recessions indicate that the industry is likely past the trough, even though it will not feel like a recovery for some time, according to Bodino. "So the questions become, how bad did it get and what did we learn? The last recession was 18 months from peak to trough, and here we are on the doorstep of 18 months since the last peak," he notes.

In 2010, Bodino says he looks for consolidation primarily among the number of players in each basin, but also possibly among the absolute number of producers in the business. "In every new play you see the land grab first," he says. "Then the consolidation based on who has the lower cost of capital and access to infrastructure. In the end, you have a handful of players with the lion's share of the production. It seems like the same four or five big players are left in each shale play. They either get in early and do not overpay for acreage, or they come in later and buy out the early movers (as with ExxonMobil acquiring XTO)."

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In most cases, Bodino notes, the wisest move is "to pay for acreage and exploration with equity, and to pay for acquisitions and development with debt." To help ensure cash flow, Bodino says he is still an advocate of hedging. He notes, however, that more than a few players have let their hedge programs roll off, whether by design or necessity.

Commodity Of Commodities

Two themes continue to resonate for the first half of 2010, says Dan McSpirit, vice president with BMO Capital Markets in Denver: Lower commodity prices for gas, and as a result, a greater distinction placed on those producers that thrive versus those that simply survive. He adds that the former class of producers has captured inventories of lower-cost production and possess greater liquidity to fund growth–whether organic or otherwise. "Absent any meaningful change in demand drivers, the scarcity premium for the commodity will be absent and natural gas will remain the commodity of commodities," he holds.

With the development of unconventional resource plays, McSpirit acknowledges that for the investment community, it seems like "overnight the supply of economically recoverable resource has overwhelmed demand, almost chronically so. We are drowning in molecules."

He notes that in 2009, leading independent gas producers got serious about trying to stimulate demand, forming America's Natural Gas Alliance and becoming more active in supporting other organizations fostering consumption of the affordable, plentiful and environmentally friendly energy resource. Yet, McSpirit says the seasonal nature of natural gas demand has not gone away.

"That will continue unless we hear from Washington that natural gas will play a larger, more meaningful role in our nation's energy future, especially as it relates to seeking alternatives to imported oil for transportation fuels. That would go a long way toward rerating natural gas-leveraged companies in the public capital markets," he comments.

Even without the ExxonMobil-XTO deal or other outright acquisitions, McSpirit says he expects to see more shuffling of assets in 2010. "Many firms that bought in the bonanza of 2008 have leases that are on the clock and require development within a short time, most measured in a three-year term. Good commodity market or bad, good capital market or bad, they have to drill or give up their positions," he points out.

The shakeout may start as producers and investors prepare for the spring redeterminations for bank loans in April and May, McSpirit predicts. "We have not observed much by way of banks applying pressure to producers, but if there is no improvement in the price of gas over the first quarter, we may see some squeeze on credit lines."

While the U.S. and global economies continue a slow–but real–recovery in 2010, oil prices are likely to ease while natural gas prices inch higher throughout the year, industry analysts say.

Overall business conditions for domestic producers have greater potential than they did last year, observes Madden. "We conducted an informal survey of independent producers last year, and they all told us that they had no choice but to stop drilling. Looking into 2010, the price recovery in oil gives some opportunities in that market. The outlook for natural gas going into 2009 was bleak, and al-

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Madden notes two unusual developments from 2009 that will continue into the new year. "One is that the price of oil continues to be not subject to fundamentals. It simply does not conform," she says, noting that all the usual metrics are out of alignment: the dollar versus the price of oil, and the relative value of oil to natural gas on a Btu equivalent basis.

There are many reasons for the deviation, Madden adds, including spare production capacity, peak oil indications, government policies at home and abroad, and demand in developed versus developing countries. "The longer producers go without a long-term investment plan, the more at risk they are," says Madden.

Changing Industry Metrics

In other unusual developments, Madden notes that some of the industry's time-tested metrics have lost some of their predictive capabilities. "Gas-to-oil Btu values and rig counts have certainly not become irrelevant, but the traditional correlations have been significantly reduced as indications of future trends."

She explains that because many laterals are drilled from one pad, rig count is much less closely correlated with the number of new wells coming into production. Also, oil prices have come to reflect oil's new role as an inflation hedge and a geopolitical commodity that can be completely separate from its inherent value as a fuel or feedstock.

Bruce Bullock, director of the Maguire Energy Institute at Southern Methodist University's Cox School of Business, agrees that the old oil-to-gas Btu ratios do not hold as they once did, but he suggests that a new ratio may become clear before too long. "Oil has become a financial commodity, while gas has not, yet. We have been waiting for the gas market to globalize, just as the oil market did, and to some degree, that has happened with liquefied natural gas, but there is still a long way to go before it is a truly global market," he states.

Nariman Behravesh, chief economist at IHS Global Insight in Lexington, Ma., concurs on the changing importance of rig counts. "The rig count does not matter as much anymore because it is no longer an accurate picture of extractive capacity. It is still one measure of input, but not of output. The problem is that I am not sure there are yet other ways of measuring that output."

Instead, Behravesh says he focuses on the metrics that are still essential, especially the trading bands for oil and natural gas. "I do not see a \$70-\$80 a barrel range continuing for oil," he says. "Markets got a little ahead of themselves and the rise to \$80 a barrel was largely related to investor activity. That is hot money, but not necessarily smart money. A lot of commodities, notably gold, but others as well, are also rising without any big increase in fundamental worldwide demand. There is a lot of liquidity in the commodities market. I see oil prices easing back to around \$65 a barrel. Where and when the recovery actually takes hold, the price of oil may rise again."

With oil valued higher on a Btu equivalent basis than natural gas, the U.S. rig counts are reflecting major movement in the ratios of rigs drilling for oil versus gas. As opposed to five years ago, when only one in every 10 active rigs was drilling for oil, about 35 percent of the 1,161 U.S. rigs active in mid-December were targeting oil, according to data from the Baker Hughes North American Rotary Rig Count.

"At current prices, several companies are investing in secondary and tertiary recovery projects in older oil fields," says Bullock. "We will continue to see carbon dioxide floods and other types of EOR projects as long as oil stays above \$50-\$60 a barrel. There is no question that oily assets have an advantage over gassy ones right now."

However, Bullock puts that price deck for investment about \$20 a barrel below mid-December prices because he says he does not expect oil to remain at \$70-\$80 a barrel. "The fundamentals just do not support that level," he holds. "A price in the \$50-\$60 a barrel range is more sustainable."

Feast And Famine

The good news on the natural gas pricing front, according to Behravesh, is that prices are not likely to dip much lower.

"I see oil prices easing to around \$65 a barrel. Where and when the recovery actually takes hold, the price of oil may rise again. The price of natural gas is not going back to double digits anytime soon, varying between \$3.50-\$4.50 an Mcf on the low side and \$5.50-\$6.50 an Mcf on the high side."

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However, the bad news is that he says they probably will not rise much either in the foreseeable future. “On the demand side, the period of famine is going to be fairly long before we return to the feast,” he quips. “It is going to take a while to burn off the overhang of capacity.”

On the supply side, Behravesh says the domestic gas sector will continue to be a victim of its own success over the next 12-18 months, with the recovery in the gas market mirroring the gradual recovery of the U.S. economy. “The situation will remain difficult from a price perspective,” he predicts. “There will be some upside, with prices varying between $3.50-$4.50 an Mcf on the low side and $5.50 to perhaps $6.50 an Mcf on the high side through 2011, with upside gains related mostly to reductions in supply from production declines and well shut-ins. The price of gas is not going back to double digits anytime soon. Yes, the recession is officially over and the recovery has officially begun, but it is very modest. It is not going to feel like a recovery for another year.”

Underscoring the outlook for a tepid recovery, Bullock says he is “not pessimistic, but very mildly optimistic” about the broader U.S. economy. “The recovery will be very slow, coming in fits and starts, and without a lot of job growth or industrial activity,” he relates. “We do not see gross domestic product growing much more than 2.0 percent for 2010.”

Referring to the letter shapes that are commonly used in discussing the curve of economic activity, he suggests the recovery will resemble a U, with a slow start off the bottom but accelerating through 2011. “We definitely will not get a sharp V bounce,” Behravesh cautions.

And as for the dreaded double-dip or W-shaped recovery, Behravesh says that is not likely. “What is more possible is a soft W, where there is a relapse in growth, but it does not go negative.”

By the numbers, Behravesh says he expects 2010 to see 2.2 percent growth in the U.S. economy, followed by 2.9 percent in 2011 and a robust 3.7 percent by 2012.

“The implication for domestic independent producers is that demand is not going to be great for oil or gas. It is going to take a while for us to dig out of the demand hole,” he states, adding that the outlook for global demand recovery is similar, but with regional variations.

He says China will get its groove back this year, returning to 10 percent growth, spurred mostly by massive stimulus spending by the central government.

In contrast to price, supply and demand variables, Bullock concludes that the most volatile factor in domestic energy markets is politics. “The situation in Washington is extremely unpredictable,” he says. “Unemployment is likely to remain stubbornly high for years to come, which could lead to some strange decisions, which may or may not benefit the industry. Good policy and good politics do not always go hand in hand.”

Fostering Demand Growth

Producers are hoping the time is right to implement some sound policy when it comes to redefining the role natural gas plays in the nation’s energy mix. In a Dec. 14 op-ed piece in *Forbes* magazine, T. Boone Pickens cited a report from the Potential Gas Committee, indicating that the United States had as much as 2 quadrillion cubic feet of natural gas reserves, or a century’s worth at the current consumption rate.

Analysts note that the 100-year mark is a hugely important psychological and political milestone in the public sector. That is because it finally puts gas into the same ballpark as coal, which has long boasted of reserves measured in centuries. The snag to organically growing natural gas consumption in the United States is no longer on the supply side, but on the demand side, according to David Trice, chairman of America’s Natural Gas Alliance, an association formed in March 2009 by 29 of North America’s largest independent natural gas operators to foster domestic demand for gas.

With the industry proving up vast new supplies, the logical next step to reducing reliance on imported oil while promoting economic and environmental benefits is to expand the market share for clean-burning domestic natural gas. That objective cannot be accomplished overnight, of course, but initiatives are under way to move the needle over the long term.

“Our constituents inside the Beltway have recognized the abundance of natural gas,” says Trice. “We have been focusing on the environmental benefits, but what resonates most strongly today are jobs and economic development.”

That early traction that ANGA and other groups advocating natural gas are now getting on the political front may get another boost come November and the midterm elections cycle, suggests McSpirit. In terms of getting the message across about the benefits of natural gas, he says ANGA already has shown that the industry is less fragmented than it used to be, and is promoting an enlightened self-interest. “The solution that is natural gas is more clearly and collectively marketed by the industry these days. That is a good thing,” McSpirit stresses.

There are three key political factors that can be used to encourage natural gas demand, McSpirit contends. “Of course, the first is national security for a domestic resource as opposed to an imported one. Also, it fits with climate legislation. Those are well known. But what is emerging this year is unemployment. That will really motivate elected officials. Come November, nothing will be more important

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than jobs," he insists.

Developing the economy based on increased domestic natural gas production and consumption will create scores of high-paying jobs and tax bases all across the nation, and generate huge economic benefits on the federal, state and local levels, notes Trice, who also serves as nonexecutive chairman of Newfield Exploration Company.

Key Market Sectors

Outside Washington, Trice reports that ANGA has gotten some attention with its "eureka moment" media campaign, and is ramping up efforts to gin up support and new business across all consuming sectors. "We have been talking to the American Gas Association about reaching out to consumers," Trice updates. "On the industrial side, we have met with the American Chemistry Council and some of its members to discuss the abundance of natural gas, and there is evidence we are making progress in the utility sector."

Electric generation is a key market sector for natural gas, Trice adds, noting that utilities are beginning to recognize the new realities in gas supply, and are embracing both the economic and environmental benefits of combined-cycle turbines. One case in point is Progress Energy of Raleigh, N.C., which announced in October that it planned to invest $900 million in new gas-fired generating capacity to replace three coal-fired power plants. Construction is set to begin next year, with the gas-fired plants increasing electrical output by 550 megawatts while significantly reducing emissions, according to the company.

Another potentially huge market sector for natural gas is transportation, and a key element of the Pickens Plan advocated by T. Boone Pickens is converting fleet and long-haul trucks to natural gas. Natural gas vehicle technology is becoming increasingly viable, says Richard Kolodziej, president of NGVAmerica, a trade association for the natural gas vehicle industry.

"While there is no way to quickly replicate the gasoline distribution system in this country–which includes 180,000 filling stations–the first step is to convert the 40 percent of trucks and buses on the road today that return to a home base every night. For each of those fleets, you do not need a network of stations, but one fueling point," Kolodziej points out.

Step two, he adds, is the other major sector of the truck and bus industry that travels from one point to another. "The average light-duty sedan travels 12,000 miles a year. At 25 miles per gallon, that equates to about 500 gallons of fuel. But a Class-8, 18-wheeler truck may travel 120,000 miles a year and gets only six miles per gallon. That is 20,000 gallons of fuel. With a conversion factor of 1,000 cubic feet of natural gas to eight gallons of gasoline or diesel fuel for vehicle transportation, that would be a lot of new natural gas demand," Kolodziej notes.

For operators of fleets, not only does natural gas provide substantial benefits in terms of reducing air emissions, but Kolodziej says natural gas is much cheaper than either gasoline or diesel, equating to about $1.75 a gallon at the pump–including taxes–at a natural gas price of $8 an Mcf.

Kolodziej adds that natural gas vehicles consumed 37 billion cubic feet of gas in 2008, which was a robust 30 percent increase from 2007, and another 25 percent increase in consumption is projected for 2009, despite the economic recession. Longer term, he says NGVAmerica projects a consumption target of 1.25 trillion cubic feet by 2020. ❐