

Industry Reaction to Saudi America: The Truth About Fracking and How It's Changing the World

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Bethany McLean, the author of the Enron book “The Smartest Guys in the Room” has published an Op-Ed in the *New York Times* called [“The Next Financial Crisis Lurks Underground”](#) which includes excerpts from her recently published book, “Saudi America: The Truth about Fracking and How It's Changing the World.” The Op-Ed summarizes some key points from her book. Among other things, Ms. Mclean expatiates the thesis that was raised briefly during the recent downturn by noted short sellers that oil and gas companies’ tendency to prefer reserve growth over cash earnings is a harbinger of an unprofitable industry that will soon see large re-valuations.

This premise is at odds with the financial results discussed throughout the Fall 2018 Haynes Boone Energy Roundup as a general matter, but we thought it would be helpful to specifically address the claims in the Op-Ed that are repeated in the book. With the permission of The Mitchell Group, we have reproduced below and excellent discussion of the topic in the form of an excerpt from an email sent to an investor.

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While the article makes some interesting points regarding the importance of shale in reshaping the oil market and geopolitics, its primary thesis that shale production growth is not “economically sustainable” fails primarily due to its reliance on outdated data. To back up her claims, the author uses data sets from 2002-2012 (Chesapeake), 2006-2014 (David Einhorn) and 2012-2017 (E&P company data). Some of this data is simply irrelevant since it relates to a pre-shale industry. Most of the rest of the data is outdated since it reflects a period of historically low oil prices and/or significantly higher break-even costs within the shale industry.

Reliance on this outdated data leads the op-ed’s author to conclude that “frackers haven’t proven that they can make money.” This statement is untrue and does not reflect recent changes in the shale industry or in oil prices. As (somewhat paradoxically) noted in the article itself, both efficiency and productivity have materially increased since the beginning of the downturn. In addition, most service costs have sharply declined since the 2014 peaks. These developments have caused the break-even cost of new shale production to “plunge”. According to the World Bank, these have fallen by over 40% since 2013. While break-evens were dropping, oil prices were beginning to stabilize and rise back to normalized levels. While WTI has been fluctuating between \$65-\$70 for most of 2018, it is important to remember that WTI prices averaged \$48.66, \$43.29 and \$50.80 in 2015, 2016 and 2017, respectively.

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According to the IEA, the shale industry as a whole has reached a turning point and should create positive FCF in 2018. According to Wood Mackenzie, the larger US shale oil companies currently need only \$53/barrel to generate free cash. All else being equal, the industry’s FCF numbers should improve further in 2019 as new pipelines alleviate the current Permian bottlenecks, leading to better

pricing for producers. Based on a Twitter exchange with a Columbia professor (Jason Bordoff), it appears that the author was unaware of the improved financial condition of the industry, noting that the FCF numbers cited above “is pivotal analysis which I haven’t seen.” Despite rising oil prices and revenue, the industry has remained focused on free cash flow maximization and total shareholder returns over production growth. This focus has driven numerous companies to hike dividends and/or institute material share buyback programs during 2018. Going forward, reduced break even costs should allow companies to remain cash flow positive (and profitable) at lower oil prices than in the past. Even the author admits that the industry is “trending in the right direction.”

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- “A key reason for the terrible financial results is that fracked oil wells show a steep decline rate.” This is a patently ridiculous statement. Obviously, the pace of declines do not determine returns. Costs and revenue (*i.e.*, oil prices) determine returns along with the payback period. Since the payback period for shale is significantly shorter than most long-cycle projects (*e.g.*, deepwater), the production profile of shale actually mitigates investment risk, one of the (many) reasons that the world’s largest oil companies are substantially increasing their investment in U.S. shale resources.

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- “Frackers haven’t proven that they can make money.” Throughout the article, the author confuses free cash flow with profits. Since they do such a good job of explaining this point, I am going to steal the following quote from the forecasting firm Princeton Energy Advisors. “Companies growing production quickly will often be free cash flow negative, because they are using cash from operations and debt to maintain the pace of expansion. By contrast, accounting profits, which match current period revenues to current period expenses, are actually quite good for some operators. For example, we estimate underlying after-tax net income / sales at 14% for Pioneer Resources, after adjusting for one-time gains and costs. Pioneer’s underlying breakeven [ex Permian price differentials] continues to fall, now \$51.50 / barrel realized price.”