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Stratas Series: Crisis in North America Shale

Stratas Advisors

This excerpt is from a report that is available to subscribers of Stratas Advisors' Upstream, Stratas Energy Perspective, and Middle East services.

Part 2. Crisis in North America Shale

With second quarter results hitting the wires, a few key items are weighing on shalers: layoffs, reductions in capital spending and less than exciting well results.

Pressure appears to be mounting on North American shale if recent disclosures by a cadre of oil and gas companies are indicative of the broader industry. Unit costs are rising in key productive areas and recent well results in select areas are falling short of expectations. Consequently, exploration and development plans are being adjusted and capital efficiencies are again being questioned.

Looking at the change of quarterly production costs, coupled with news of lower than expected well results, leads to the belief that capital efficiency is waning. As such, operators are lowering rig counts in order to keep capital budgets in check while honing in on the optimal drilling strategies.

Should WTI prices slip below $45 per barrel for a sustained period of time, reductions in rig counts could be severe enough to slash yearend 2020 shale production by as much as 500 MBbl/d (5%) from our previous estimate of 9 MMBbl/d.

Capital Efficiency Is Down

Of the handful of public operators reporting so far, concerns have arisen as to the outlook for North American shale in whole. For starters, unit costs per barrel ($/Boe) on average from operators with recent announcements are seeing higher total production costs (up $0.40). The median increase is $0.10/Boe. Looking to the third quarter, Stratas expects average costs will rise another $0.30/Boe and median costs another $0.70/Boe.

Q/Q Change (%)	Mean	Median
Lease Operating Expense	(0.4%)	4.8%
Taxes Other Than Income	4.7%	8.9%
Gathering, Processing and Transportation	(4.2%)	0.4%
Exploration	12.6%	(32.7%)

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General and Administrative	(5.6%)	(9.2%)
Cost of Purchased Oil & Gas	11.0%	N/A
Total Production Costs	2.1%	0.8%

While uncertainty looms on the decisions to be made with operators in the near term, Stratas presents a hypothetical scenario. It is almost universally known that the shalers feel pressure to live within cash flow. It has been witnessed that as costs have risen, so too have budgets. Consequently, rigs are being dropped in hopes to obtain positive cash flow in 2020. Notably, horizontal oil rigs have dropped 12% since 4Q18 in the U.S.

But what if that isn't enough? Oilfield service operators have been stretched to the gills by trying to appease upstream operators on costs. And the jury is still out on the effectiveness on large scale development. The idea here is to maximize drilling efficiency by lowering down-time for a rig, and increase production by tighter spacing, say from 4-6 wells per section to 8-12. One operator in particular spaced its wells too closely in the Permian, resulting in excessive communication between the parent/child wells and therefore experienced less than expected production performance. The increased production costs coupled with lower expected volumes suggests that capital efficiency is waning.

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