Clear as Mud(Rocks): A Forward View of Natural Gas

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Overview: U.S. and Texas Natural Gas Supply

• What a success story! The only considerations are...
• ...downward pressure on natural gas prices...
  – How much? How long? With what consequences (more on that later)?
• ...because of tight rock dynamics...
  – The “bidness” and how to think about it
• ...and the need to re-plumb the gas system...
  – “Primer” on Texas/ERCOT gas infrastructure and flows
• ...in an extended period of consumer sovereignty.
  – Plenty of ideas. Will they all work?
Gas Price Economics (2030)

Price events above $6 can happen

S-D interactions relative to supply cost, deliverability

Price events below $3 can happen

Supply Mix

*Production (25-30+ TCF):

HH price dependent (**70-80%, “NAG”, dry; ~60% gas wells)

NGLs, Condensate, “wet” gas (oil linked, S-D, export drivers)

Oil price dependent (**20-30+, “AG”, “wet”;

Total Methane Supply

LNG In?

LNG Out?

* Canadian gas production, pipe delivery subject to same conditions; **EIA reserves reporting.

Annual average, real price; Michot Foss, OIES NG 18 (2007) and NG 58 (2011); www.oxfordenergy.org
Ever More Reliance on “Mud Rocks”

Of which (approx.):
- TX 28%
- PA, OH, WV 28%
- While: GOM OCS 1%

U.S. Energy Information Administration; Michot Foss analysis

Note: 2017 data are estimates
“Free” gas. Yay!

Byproduct of
- Hunt for liquids, especially Permian black oil;
- Over-pressured tight rock;
- Enormous gas drive “engines”.

How much? How long?

Note: 2017 data are estimates
Oil, Liquids Drive Decisions

Relative to Opportunities

Drilling targets reflect relative premiums and expectations

U.S. Energy Information Administration; Michot Foss analysis
Consequences for Producers

- Extraordinary hunt for liquids rich (black oil) acreage as producers continue to shift portfolios
- Rapid accumulation of debt (now, deleveraging)
- “Gassy” producers are lower cost but...
- …if all of the cost burden was placed on methane, would need a supporting gas price

Note: CEE 2017 results expected to be broadly equivalent.
CEE producer benchmarking, 16 companies, annual reports;
Michot Foss analysis
Consequences for Producers

- Challenges keeping spending in line with cash flow (better)
- Large contribution of depreciation to cash flow funded spending (too much)
- Reliance on external capital markets, especially for organic capex (M&A, property dispositions)

Note: CEE 2017 results expected to be broadly equivalent; slight improvement in net income, more capital discipline

CEE producer benchmarking, 16 companies, annual reports; Michot Foss analysis

Bernstein Research (right), used with permission

Source: FactSet, Company reports, Bernstein analysis (1Q17 - 4Q17 Average WTI $50.82/bbl, HH $2.95/mcf)
Note: Acquisition capex is shown in red color in above chart
Long Term Spending and Cash Flow

The “treadmill” shows up in the need for continuous outlays of capex, largely funded by accumulated depreciation and external capital.

Note: CEE 2017 results expected to be broadly equivalent; slight improvement in net income, more capital discipline.

CEE producer benchmarking, 16 companies, annual reports; Michot Foss analysis.

Bernstein Research (right), used with permission.

Source: FactSet, Company reports, Bernstein analysis, Bloomberg.
Note: The production volume is an absolute measure and differs from quarter to quarter based on number of companies included in the calculations.
For Producers, Midstream Costs have Grown

“Producer push” as opposed to “demand pull” for midstream investment
- Producers now much more constrained

Expect increase in G&A Marketing 2017

Note: CEE 2017 results expected to be broadly equivalent; slight improvement in net income, more capital discipline. CEE producer benchmarking, 16 companies, annual reports; Michot Foss analysis
Realizations: Expected vs Reported Revenue

Positive = Realized < Expected

Gassy companies have greater difficulty meeting realized revenue targets
In Sum: State of the Industry

• Improvements in cost management, so far, but
  – Midstream continues to burden producers
  – Capex will grow again as companies try to reposition
    • Acreage consolidation to pursue drilling patterns
    • The “cube” strategy of “wine rack” near simultaneous completions as companies work to manage “parent-child” well interference (charts on right, proprietary project)

• The need to drill to sustain upstream businesses is quite real
  – “Prove up” to retain, attract new capital
  – Volumes to produce sufficient funding for operations

• Given these realities + predominant “gas drive” reservoirs + midstream bottlenecks + offtake = impact on prices and spreads

Assumptions: Avg realized crude price $55; Avg realized gas price $3.20
Weekly

Deterioration of spreads

http://www.naturalgasintel.com/data/data_products/weekly?location_id=SLAHH&region_id=south-louisiana
Forward prices of natural gas delivered for each reference period at the various locations/hubs.

http://www.naturalgasintel.com/data/data_products/forward-contracts?location_id=SLAHH&region_id=south-louisiana
"Basis price" represent the differential, for each reference period, between the Henry Hub and various locations/hubs.

http://www.naturalgasintel.com/data/data_products/forward-contracts?location_id=SLAHH&region_id=south-louisiana
A fix?
Usefulness of Spreads

• Lure investment to bottlenecks and...
• ...attract monetization options...
  – *Gains from trade*
  – *End users*
• ...so long as business conditions support “optionality”.
  – *And it can be paid for.* 😊
US/NAM Gas Trade

Net Imports

12 mos to Jan 18:
-0.4 BCFD

12 mos through Jan 18:
-4.3 BCFD

12 mos to Jan 18:
5.7 BCFD

12 mos through Jan 18:
-1.8 BCFD

U.S. is about
24% of Canadian consumption (2016)

U.S. is about
47% of Mexican consumption (2016)

2013: ~2x current NA exports by 2020 to ~9+ BCFD?
As of Jan 18 ~9 BCFD

12 mos to
Jan 18:
-4.3 BCFD

Michot Foss, Chapter 3, Pricing of Internationally Traded Gas, www.oxfordenergy.org; EIA; FERC
Waha Infrastructure
Big Bets
CFE’s zonal pricing strategy intended to:

- Improve signaling for internal de-bottlenecking and expansions
- Improve price signals for imports
- Provide price signals for domestic production
Our Renaissance

- About 100 Projects
- About $90 billion
- Incremental NG demand of ~3 BCFD
Global LNG complexities...

- **“Low” demand growth (China, India, Japan, and others):**
  - Coal, nuclear, renewables have priority - energy security
  - Not enough gas infrastructure (especially storage)
  - Low gas market readiness
  - Sluggish economic growth
  - Japanese energy policy: nuclear, renewables, efficiency

- **“Surging” global LNG supply ➔ excess supply until the mid 2020s**
  - Unsubscribed U.S. liquefaction capacity
  - Parts of contracted volumes not tied to specific destinations

...and rapidly shifting terrain.

Creditworthiness of buyers is a substantial risk to global LNG trade growth.

Shell LNG Outlook 2018
Closing Thoughts

• How to keep the success story going
  – *First, do no harm*

• Ultimately, market will set pathway...
  – Cost of capital
  – Attraction of oil and gas for investment portfolios
  – Ability of producers to consolidate acreage positions in order to sustain, improve efficiencies and get off the treadmill (???)
  – Trade, petrochemicals do not provide enough “oompf”
  – Gas competitiveness for electric power is key

• ...perceptions will dictate