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One year later, how oil producers have changed their outlook

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I n August 2014, most exploration and production companies delivered their second-quarter results to shareholders. While management could not have known it at the time, the June 2014 quarter marked the peak in West Texas Intermediate crude at $106.91. Who would have imagined that almost exactly one year later on June 30, 2015, WTI would close at $59.47 only to fall further to $38 a barrel on Aug. 24, a decline more than 60 percent from the high. These quarterly reports and in-depth calls with analysts provide insight into key issues and concerns and when scrutinized with reports from a year ago provide important perspective on what management said then, now — and most importantly — what comes next.

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In August 2014, most exploration and production companies delivered their second-quarter results to shareholders. While management could not have known it at the time, the June 2014 quarter marked the peak in West Texas Intermediate crude at $106.91. Who would have imagined that almost exactly one year later on June 30, 2015, WTI would close at $59.47 only to fall further to $38 a barrel on Aug. 24, a decline more than 60 percent from the high.

Five companies — Dallas based Pioneer Natural Resources (NYSE:PXD), The Woodlands-based Newfield Exploration Co. (NYSE: NFX), Houston-based Oasis

Petroleum Inc. (NYSE: OAS), Oklahoma City-based Chesapeake Energy Corp.

(NYSE: CHK). and Houston-based Goodrich Petroleum Corp. (NYSE: GDP) — were selected for review to provide a mix of large, medium and small sized producers.

The view from June 2014

The June 2014 quarter was a good one for these five companies. Year-to-date through June, share price increases for the group ranged from a low of 14.5 percent (Chesapeake) to a high of 79.5 percent (Newfield). WTI was up 7.8 percent for the year. Earnings were solid and production had grown above expectations.

However, by the time the calls took place in the first week of August 2014, hints of what was to come were beginning to appear. WTI had retreated by almost $10 to $97. Company share prices had fallen as well, ranging from -31.2 percent (Goodrich) to -9.7 percent (Newfield).

With the benefit of hindsight, it is interesting to note that management across all companies spent considerable time answering analysts' questions about well productivity and discussing the importance of improvements in well productivity and operating efficiency in remaining competitive.

On the other hand, analysts had no questions about any company's hedge position. In their opening remarks, Pioneer, Oasis and Goodrich mentioned briefly that they had added hedges during the quarter. Each also stated, in effect, that the recent run up in the WTI price had enabled them to be opportunistic.

The view from June 2015

The reports for June 2015 and the August calls took place in a different world. Once again, analysts asked and management discussed the imperative of continued improvement in operating efficiency as the key to profitability in a low price environment.

Hedge positions received considerable attention. Pioneer cited the strength of

the "great returns of superior derivatives position," while Newfield characterized its hedges as a "differentiator amongst our peers." All companies benefitted its hedges as a "differentiator amongst our peers." All companies benefitted from their WTI hedges.

For the five companies in total, second-quarter revenue from oil without hedges was $1.5 billion and revenue with hedges was $2 billion. Hedged revenue was $500 million or 33 percent higher than unhedged. On average, the unhedged price per barrel fell by 47 percent while the hedged price fell by only 23 percent from year earlier levels.

But the hedges are burning

Most companies have hedges extending 18 to 36 months out, with closer periods weighted more heavily. Hedge structures differ between companies due to different production profiles and capital spending plans. What they do have in common, however, is the market determined futures strip, which provides a price for WTI delivery at a future date. As time goes by, the future moves toward the present and futures contracts must be rolled outward to maintain the desired maturity.

As the downward shift in the futures strip shows, the risk all producers face is WTI staying lower for longer and the sharp step down in hedged price as current hedges roll off. Goodrich Petroleum's hedge expires at year-end 2015. If nothing changes, the company faces a revenue cliff. The other companies are hedged for 2016 between 25 percent and 75 percent of recent production. If WTI stays lower for longer, these hedges provide a head start in the race between lower product prices and increased productivity. The amount of lead varies by company and the hedging structure in place.

By the numbers

$106.91 — The June 2014 quarter marked the peak in West Texas Intermediate crude

$59.47 — June 30, 2015 WTI closing price

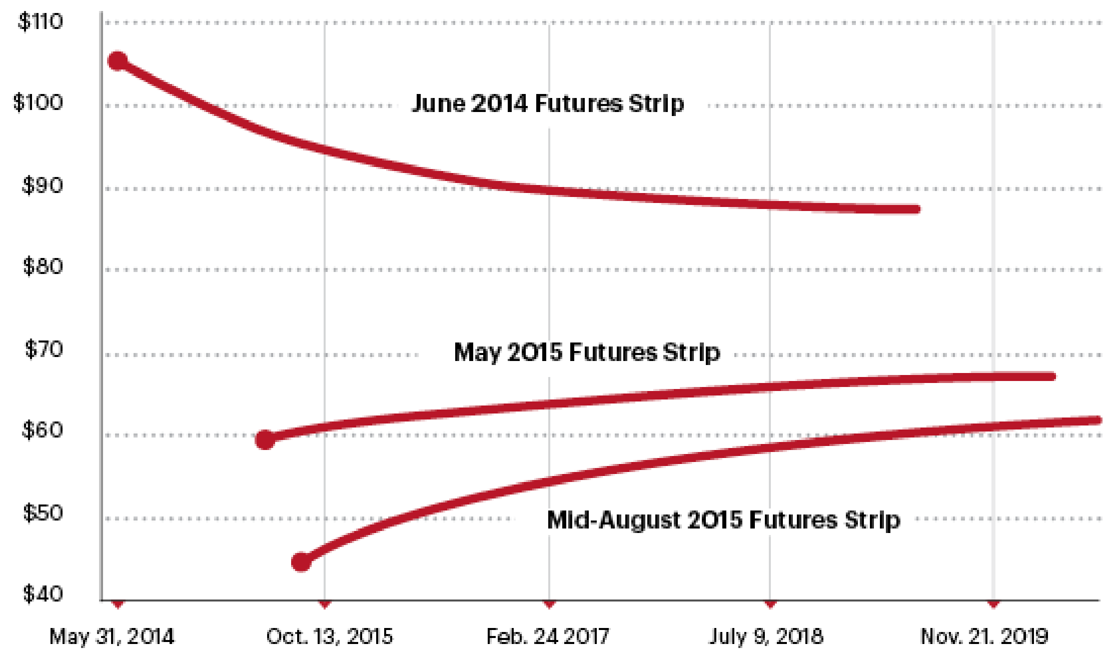
60 percent — Decrease in WTI by mid-August 2015 at $44 a barrel from the high

just a little more than a year ago

WTI Futures chart.png

WTI Futures chart.png

▶ WTI FUTURES STRIP (PRICE FOR WTI DELIVERY AT A FUTURE DATE)



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