BIZVOICE

OPINION

To drill or not to drill – that is the question

BY SCOTT A. BAYLEY
AND GUY BRASSEUX

Oil and gas producers face a dilemma with oil prices standing at nearly half of where they were a year ago: Should they continue to drill or should they cut back and reduce costs?

Well economics are challenging when oil prices are down. Financial uncertainties abound and risks are complex – yet the outcome requires a “drill” or “no-drill” decision. Some of the input is technical, such as how much oil the well will produce, production decline rates, estimating the life of the well and the cost to drill, complete and produce.

Financial inputs such as the price per barrel of oil sold are difficult to project next week, let alone two decades from today. Fortunately, shale well production comes on-line quickly and rates decline early in their lifetime making long-term projections less relevant. Other wells take decades to plan, drill and produce. At a time when tomorrow’s oil price is anyone’s guess, projections decades into the future are less than scientific.

Unwarranted pessimism or optimism is a recipe for disaster. Consider this example from the 1980s: The price of oil had risen from $5 to $30/bbl during the 1970s with correspondingly optimistic projections for the future showing $50 per barrel within 10 years. Using this forecast, drilling made sound economic sense. Slightly less optimistic price forecasts continued as drilling rates gradually slowed until the price plunge of 1986 caused the drilling industry to collapse.

Here are two different takes from individual energy economics experts as producers face their crossroads:

TO DRILL

GUY BRASSEUX

America has been striving for energy independence since the early 20th century, and nonconventional drilling has opened the door for achieving this objective. For many years, energy independence has been a national security concern. Protecting America’s oil supply is seen as an imperative to protect jobs and keep our economy humming. Many blame the United States’ obsession with this objective as the reason our government has engaged in armed conflicts across the seas. Unconventional production can be one of the keys to reducing our dependence on foreign oil, along with a reduction in demand from increased efficiency and alternative resources.

Despite increased domestic production, the U.S. is still a net importer of crude oil and a net exporter of petroleum products. Increasing levels of domestic oil production through 2020 results in lower crude oil imports and higher throughput at U.S. refineries. Higher refinery throughput increases production and net exports of refined petroleum products like motor gasoline and diesel fuel.

If U.S. oil and gas onshore and offshore resources are exploited, with a little luck, the gap between production and domestic consumption will close, especially if gas exports offset oil imports.

Energy independence will require the U.S. to produce another few million barrels of oil and supply the domestic market with gas, at the same time reducing energy consumption. Energy imports will also fall if, as seems likely, oil prices remain low long term and government policy to promote fuel-efficient vehicles is achieved.

It is in our best national interest to achieve independence from foreign sources by developing our own resources.

Guy Brasseux is the associate director of Houston-based Accumyn Consulting.

NOT TO DRILL

SCOTT A. BAYLEY

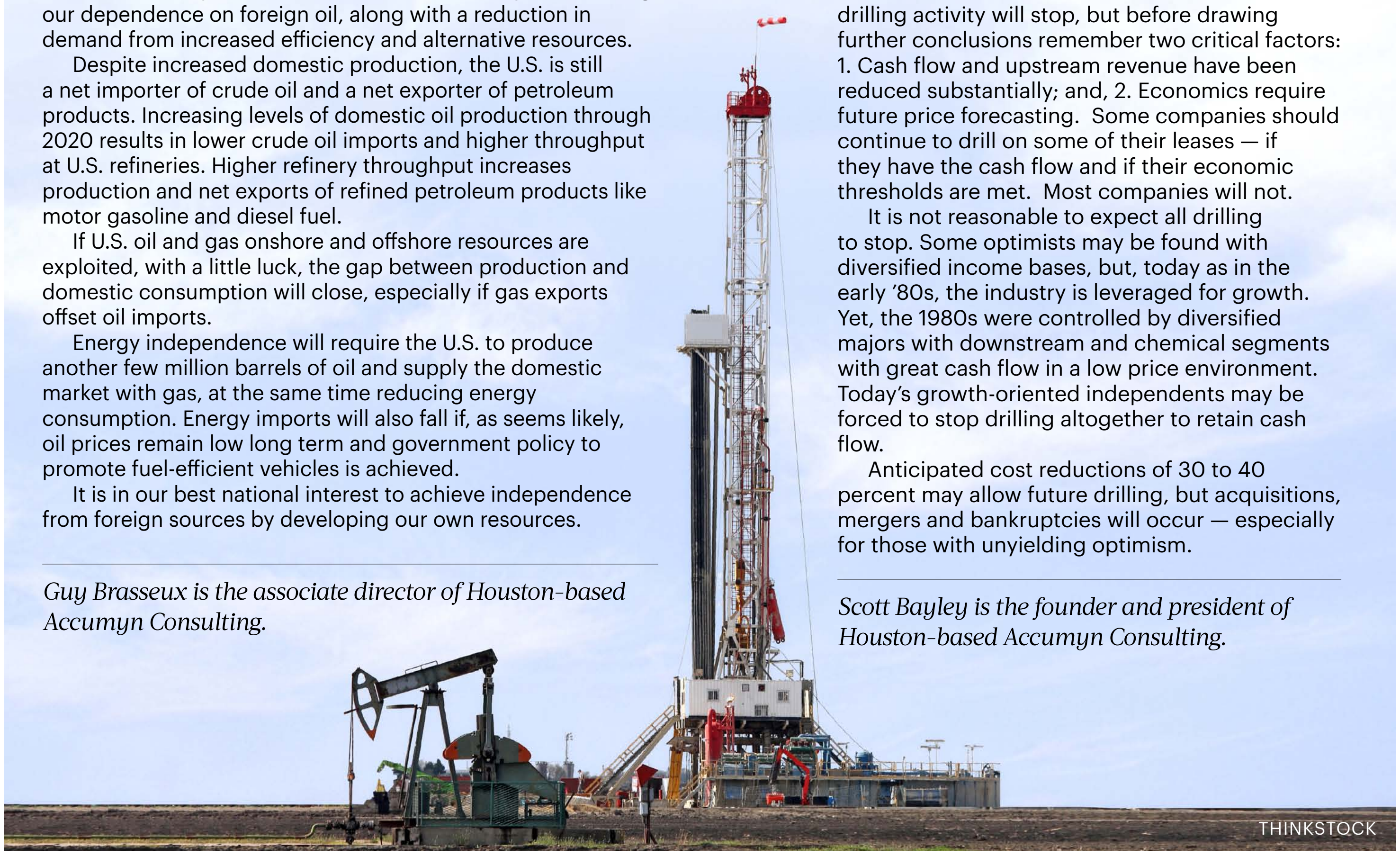
Average break-even cost reported by operators in different shale basins ranges from $31 to $98/bbl — quite a variation when contrasted with today’s price of $56.60/bbl. Note that each basin has different fields (some more economical than others), each operator has different practices (some more economical than others) with each well having its own unique performance and cost.

From this data, it’s safe to conclude that some drilling activity will stop, but before drawing further conclusions remember two critical factors: 1. Cash flow and upstream revenue have been reduced substantially; and, 2. Economics require future price forecasting. Some companies should continue to drill on some of their leases — if they have the cash flow and if their economic thresholds are met. Most companies will not.

It is not reasonable to expect all drilling to stop. Some optimists may be found with diversified income bases, but, today as in the early ’80s, the industry is leveraged for growth. Yet, the 1980s were controlled by diversified majors with downstream and chemical segments with great cash flow in a low price environment. Today’s growth-oriented independents may be forced to stop drilling altogether to retain cash flow.

Anticipated cost reductions of 30 to 40 percent may allow future drilling, but acquisitions, mergers and bankruptcies will occur — especially for those with unyielding optimism.

Scott Bayley is the founder and president of Houston-based Accumyn Consulting.



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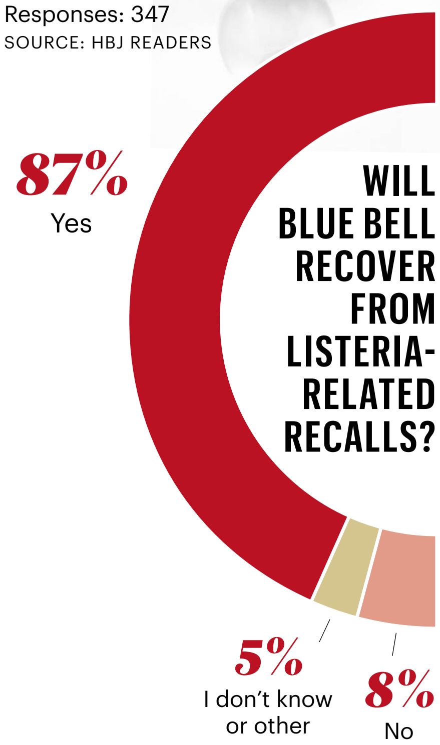

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