Energy Boom Can Withstand Steeper Oil-Price Drop

Some Smaller U.S. Producers Are Likely to Face Pinch From a More-Modest Decline

Oil drilling in Texas’s Eagle Ford Shale would remain economic at an oil price of $53 to $65 a barrel, one brokerage says BLOOMBERG NEWS

By RUSSELL GOLD, ERIN AILWORTH and BENOÎT FAUCON
Updated Oct. 29, 2014 8:47 p.m. ET

Oil prices would need to fall at least another $20 a barrel to choke off the U.S. energy boom, industry experts say, though some smaller American producers would face serious problems from a more modest decline.

Small and midsize companies—not global giants—are behind the surge in U.S. oil output, which hit 8.97 million barrels a day earlier this month, according to federal statistics. Some of these drillers have taken on a lot of debt, which was easier to justify when oil was going for as much as $107 a barrel just four months ago.

U.S. crude closed Wednesday at $82.20 a barrel, and far less in some parts of the country where few pipelines are available to move it to refineries. Lower oil prices mean drillers will have less cash to cover their borrowings, especially if crude prices tumble more.

So far, American companies haven’t reacted to the recent oil-price drop: The number of drilling rigs searching for onshore oil in the U.S. has risen slightly since oil prices peaked June 20.

The Organization of the Petroleum Exporting Countries seems to be betting that will
change soon. Abdalla Salem el-Badri, OPEC’s secretary general, predicted Wednesday that if current prices hold, half of the U.S. oil that is fracked from shale formations will be uneconomic, leading companies to stop producing it.

WSJ Radio
Russell Gold explains to WSJ’s Hank Weisbecker how falling oil prices affect the energy sector.

00:00 | 03:12

That view is at odds with most U.S. forecasters, who say output can remain steady at current prices because companies have cut their costs by finding ways to produce oil more efficiently. For example, the amount of oil coming from each new well in South Texas has nearly doubled since 2012, federal data show.

Marianne Kah, chief economist of ConocoPhillips, said oil prices would need to fall to $50 a barrel “to really harm oil production” in U.S. shale basins. She said 80% of the American shale sector—in which ConocoPhillips is a major operator—is profitable at prices between $40 and $80 a barrel for benchmark West Texas Intermediate crude.

Jason Bordoff, director of Columbia University’s Center on Global Energy Policy, said he believed prices would have to fall much further to put significant pressure on the U.S. energy boom. “I am not sure if $80 is enough,” he said. “You might need $60 or $65 to really see a stress test.”

Occidental Petroleum Corp. ’s chief executive said last week that he saw plenty of drilling opportunities in the Permian Basin in West Texas at current prices. “We think there’s a lot of economic oil at $75,” Steve Chazen said on a call with analysts. “Do I think there’s a lot of economic oil at $50? No, I don’t.”

The Permian, where U.S. drilling activity is heaviest, will be profitable for companies to drill at U.S. oil prices of $57 to $75 a barrel, depending on location, according to research from Robert W. Baird & Co. As a result, companies active there, such as Chevron Corp. , Apache Corp. and Pioneer Natural Resources Co. , are likely to keep drilling.

The Eagle Ford Shale, located farther south in Texas and home to Marathon Oil
Corp., Anadarko Petroleum Corp. and EOG Resources Inc., would remain economic at even lower prices—$53 to $65, according to Baird. North Dakota’s Bakken Shale, which is the focus of companies including Continental Resources Inc., Whiting Petroleum Corp. and Hess Corp., comes in at $61 to $75 a barrel.

To be sure, even small price drops could begin to affect production around the margins. “The clear losers in a low-price environment are going to be smaller companies that are overleveraged,” said Daniel Katzenberg, a Baird analyst. The downturn will be particularly tough on companies drilling in areas without much history of oil production. Costs tend to be high in these areas, which include the Tuscaloosa Marine Shale in Louisiana and Mississippi and some relatively unexplored shale formations in Oklahoma.

Wall Street already is trying to sort out survivors from likely losers. Among the latter is Goodrich Petroleum Corp., a relatively small Houston company whose shares have plunged nearly 70% since oil prices began falling in June. The New York Stock Exchange Energy Index has fallen 16% over the same stretch.

The company’s problems? Most of the wells it drills are in the Tuscaloosa Shale, where the industry hasn’t drilled enough to lower costs or improve efficiency. Making matters worse, Goodrich has burned through almost all of the $49.2 million it had on hand at the end of 2013, and its debt compared with its cash flow is higher than normal for U.S. oil and gas companies.

Goodrich didn’t respond to requests for comment.

The current price environment is a bit like a stress test to determine which companies have their financial and operating houses in order. Those that spent too much to lease property to drill, or have high operating costs, are most likely to suffer.

“If you didn’t overpay for acreage, you will get by just fine,” said Ken Morgan, director of the TCU Energy Institute at Texas Christian University in Fort Worth. “But if you paid an arm and a leg to get in the game, banking on $95 oil, there could
be trouble and significant belt-tightening ahead.”

Even so, companies have strong incentives not to dial back on drilling. They are likely to be reluctant to let go of their well-site crews after training them to operate efficiently.

And nobody wants to be the first to cut production, a move that would help competitors. “If you think it’s hard to get 12 OPEC nations to act in concert, try getting thousands of independent operators to agree to react to lower oil prices,” said R.T. Dukes, a senior analyst at Wood Mackenzie.

Many companies have hedged their oil production, ensuring a good price for part of it. And energy producers’ debt typically isn’t due for several years.

“They have clear sailing for 2015, but beyond that and I think many of them could be hurting,” said Robert Hefner III, founder and owner of GHK Co., an Oklahoma City energy company.

Noble Energy Inc. executives told investors earlier this week that the company would revisit its spending plans if oil prices continued to fall. But the Houston company said it had hedged its output to protect itself from price swings. Noble, which has a stock-market value of about $21 billion, also drills offshore, so it can shift production in pursuit of the highest returns, an option many shale-focused drillers don’t have.

“We’re going to be sensitive to our balance sheet,” said Noble CEO David L. Stover.

The first pinch could be felt by oilfield-service providers, as producers seek to reduce their costs for services such as drilling and fracking. Halliburton Co., which helps oil companies drill their wells, has significant exposure to the U.S. shale boom; its stock has fallen 23% since late June.

Dave Lesar, the company’s chairman and CEO, said on a conference call last week that Halliburton hasn’t detected any slowdown by its U.S. customers heading into 2015.

**Write to** Russell Gold at russell.gold@wsj.com, Erin Ailworth at erin.ailworth@wsj.com and Benoît Faucon at benoit.faucon@wsj.com