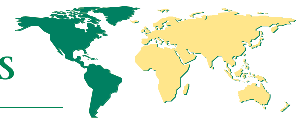

US producers less protected in 2016

Output is not as heavily hedged for next year as in 2015

Houston—US crude production is not as heavily hedged for 2016 as it would usually be by this time of year, and many of the existing hedges will draw to a close by the end of 2015, leaving producers more exposed to the low-price environment than they have been thus far.

FEATURE

Pioneer Natural Resources and EOG Resources, two of the largest Permian producers, for example, both have crude output hedged to the end of 2015. EOG is getting an average price of $89.98/b for 10,000 b/d, CFO Tim Driggers said, in a year in which the NYMEX front-month light sweet crude contract has seen an average settle of $50.89/b.

Pioneer has a lower-priced hedge at $71/b for 90% of its production, CEO Scott Sheffield said, but it is for a higher volume—Pioneer produced 99,567 b/d in the first half of 2015.

But those hedges both expire at the end of the year, and producers have not yet reached that level of hedging for 2016.

Upstream companies are generally hedged 50%-60% for 2015 and currently are about 20% hedged for 2016, Talara Capital Managing Partner David Zusman said.

"Normally they would have hedged more by now, but prices are low and companies are hesitant," Zusman said. "People are looking to add hedges on any rally in oil, and wish they had hedged more."

June and December 2016 NYMEX WTI futures trading volume averaged 39,121 and 37,716 contracts, respectively, in the week ended October 9, up from an average of 22,324 and 25,710 contracts the prior week.

The increase corresponded with a rise in prices, with the June contract closing October 9 at $52.82/b, up $3.91/b week on week, and the December contract closing at $54.14/b, up $3.53/b. Higher volume is indicative of increased activity on the futures market, some of which may be related to hedging, but on its own it does not necessarily mean greater hedging activity.

For the most part, Zusman said Talara is a "big fan" of hedging over time.

"Industry has enough risk—geological and operational," Zusman said. "Any time you can effectively mitigate risk and lock in a margin, you should do it."

Pioneer, at least, has 75% of its production hedged at close to $66/b in 2016, but reduced hedges mean reduced profitability as long as prices remain low.

"These hedges were trading windfalls for the producers this year," said Anthony Starkey, energy analysis manager at Platts unit Bentek Energy. "The millions they made on those trades go away after this year, and so they are fully exposed to commodity prices today without that protection."

That exposure would cut into cash flows, which could mean significant production declines for some of these companies, Zusman said. He said that if drilling plans do not adjust, the industry's spending would be 130% of cash flow.

Zusman said that "2016 will be all about companies and boards mandating a shift to spending within cash flows. This should result in 10%-20% additional spending cuts and fuel a further reduction in the US rig count. People still doubt it, but we are increasingly confident."

Starkey, though, said that there are still lines of credit available to many of these production companies.

"The question really comes down to how much longer the investment community keeps cash flowing to these guys," Starkey said. "In a zero interest rate world, the answer, so far, has been for quite a long time."

Capital should have dried up for some of the producers already, given how much cash they have been working through, Starkey said.

"But hope springs eternal, and that hope, right now, is pinned on the notion that oil prices will recover, and these guys will turn profitable in the future."

But for those companies that cannot make money without their hedges, even cutting production will not change anything, Starkey said.

"If you just stop drilling to save cash, well, your cash depletes anyways because of the decline profile of shale wells," Starkey said. "You have to drill to keep fresh cash coming in to fund your operations."

Next year will really be about who has been able to cut costs and raise efficiency enough to survive exposure to the low-price environment, Starkey said.— *Joshua Mann, Starr Spencer*

California LCFS credits market heating up

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3.5% in 2017, 5.0% in 2018, 7.5% in 2019, and 10% in 2020 and beyond.

The program has been held at 2013 CI reduction levels of 1% below 2010 for the last few years while the California Air Resources Board rewrote the LCFS rules, as ordered by a state appeals court.

Credit prices have surged over the last several weeks, after having averaged $28/credit in July, according to CARB. Credits were heard traded at $69/credit on September 25, after the CARB readoption, which included a maximum price cap of $200/credit aimed at tamping down volatility.

Brokerage Progressive Fuels Limited said in a note Thursday that "there seems to be a growing sentiment that LCFS [credit prices] will take off in Q1 of 2016 and reach values close to its cap of $200 later that year."

The oil industry, which has repeatedly sought to overturn the LCFS, has warned of fuel shortages in the later years of the program, when refiners will be unwilling to bear the cost of program compliance.

But fuels consultant Bob van der Valk said he does not foresee any such shortages.

"The major oil company refiners will be complying without much resistance in the hopes it squeezes the independent refiners into having make substantial capital investment into their aged refineries," he said. "Fuel pricing will be affected but it is not going to be an obstacle to most consumers as California consumers have not been objecting to the current additional fees being passed along by the refiners to them."

Data released by CARB in late September showed that 5.42 million credits have been banked through the end of the second quarter this year. About 1.21 million credits were generated in the quarter, compared to about 658,000 of deficits.

Deficits are generated when a fuel's CI is above the baseline set by CARB, while credits, which do not expire, are generated for alternative fuels production.— *Herman Wang*

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