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Can $50+ Oil Prices Turn Around the Energy Sector?

It's common knowledge that the U.S. energy sector has produced more bankruptcy filings than any other industry sector since 2015, but few outside the industry appreciate what a dismal year 2020 was in the oil patch.

The U.S. energy sector has seen more than 500 bankruptcy filings since 2015, including 108 filings in 2020 (**Exhibit 1**), according to data from Haynes Boone[1] – the worst year for filings since 2016 when the sector nearly collapsed following OPEC's momentous decision in late 2014 to end its role as a swing producer that stabilized global oil prices. The energy sector endured wrenching contraction and transformation to survive the collapse in oil prices that ensued in 2015-2016 and got off the mat in 2018-2019 before taking another knockdown blow last year. With oil prices now holding above $50 per barrel, global energy consumption on the rise again and the prospect of a robust economic recovery kicking in once COVID-19 vaccinations are widely rolled out, let's consider whether the U.S. energy sector is poised for a rebound.

In some respects, 2020 was a worse year for the energy sector than 2016. While the number of energy-related bankruptcy filings last year trailed 2016 by nearly 30%, total liabilities at filing approached $100 billion last year, topping 2016's total of $92 billion.[1] Moreover, drilling activity, as measured by active rigs, touched a multi-decade low of 220 in August, easily taking out the previous low of 330 in mid-2016.[2] Overall, U.S. land rig activity fell by more than 50% in 2020, closing the year at nearly 350 active rigs (**Exhibit 2**). Consequently, the oilfield service companies (OFS) that perform drilling and completion services accounted for approximately 60% of all energy-related bankruptcy filings in 2020.

Beyond the pandemic's negative impact on the global economy that caused energy consumption to drop by 20% in mid-2020, the decline in drilling activity also reflects a breakdown of the economic model that supported shale well drilling for over a decade.

Tight oil wells drilled in shale formations generally can be characterized as high IRR, short lived projects whose reserves are substantially depleted within three to five years of well completion. Cash flows from these wells typically have been reinvested to drill sister wells on reserve-rich tracts—often, wells with less attractive economic returns than initial wells due to falling pressure and lower recoveries in these basins. The short-lived nature of shale wells required substantial reinvestment to maintain or increase reserves. This longstanding paradigm changed in 2020.

Capital markets are no longer supportive of the business model that requires ongoing reinvestment of cash flows into new drilling. Capital market activity by independent exploration and production (E&P) companies for the last year has been devoted to liability management, refinancing activity and cash preservation. Scotiabank estimates that capital expenditure programs by U.S. independent E&Ps and majors fell by 49% (YOY) in 2020 and is poised to decline again this year.[3]

Recall that drilling activity recovered smartly following the 2016 wipeout, with the active land rig count more than doubling off its 2016 lows within one year and again reaching 1,000 rigs by mid-2018 — more than halfway back to its pre-2015 highs (**Exhibit 2**). This rebound in drilling activity occurred mostly with oil prices having recovered to the $55-$65 range, not too far off from where we are today. Some producers were able to lower the breakeven oil cost for certain shale wells to the $50 per barrel range or lower thanks to the efficiencies and wide usage of pad drilling. In fact, U.S. oil production reached an all-time high of nearly 13 million barrels per day in late 2019 when oil prices were almost 50% lower than pre-2015 prices. That hardly sounds like profit-maximizing behavior.

This time it seems there is little desire from investors or lenders to go down this road again. Scotiabank expects the U.S. rig count to remain below 600 through 2025, with the number of horizontal wells drilled annually expected to stay at least 50% below levels of 2018-2019 through mid-decade.[3] Higher energy prices since year end might boost this forecast a bit but it's doubtful that we'll witness the drilling rebound we saw in 2017-2019.

Perhaps replacing the old mantra of "Drill, Baby, Drill" is the less catchy slogan, "Buy, Baby, Buy." The second half of 2020 saw a flurry of large M&A deals among producers that may signal the next phase of life in the oil patch — rapid consolidation. Prominent deals saw huge independent E&Ps buying merely large ones or majors buying large independents, including ConocoPhillip's $10 billion acquisition of Concho Resources, Pioneer Natural Resources' $5 billion purchase of Parsley Energy, Devon Energy's $3 billion purchase of WPX Energy, Diamondback Energy's pending $2 billion acquisition of QEP Resources and Chevron's $5 billion purchase of Noble Energy. (All these amounts exclude debt assumed by the purchaser.)

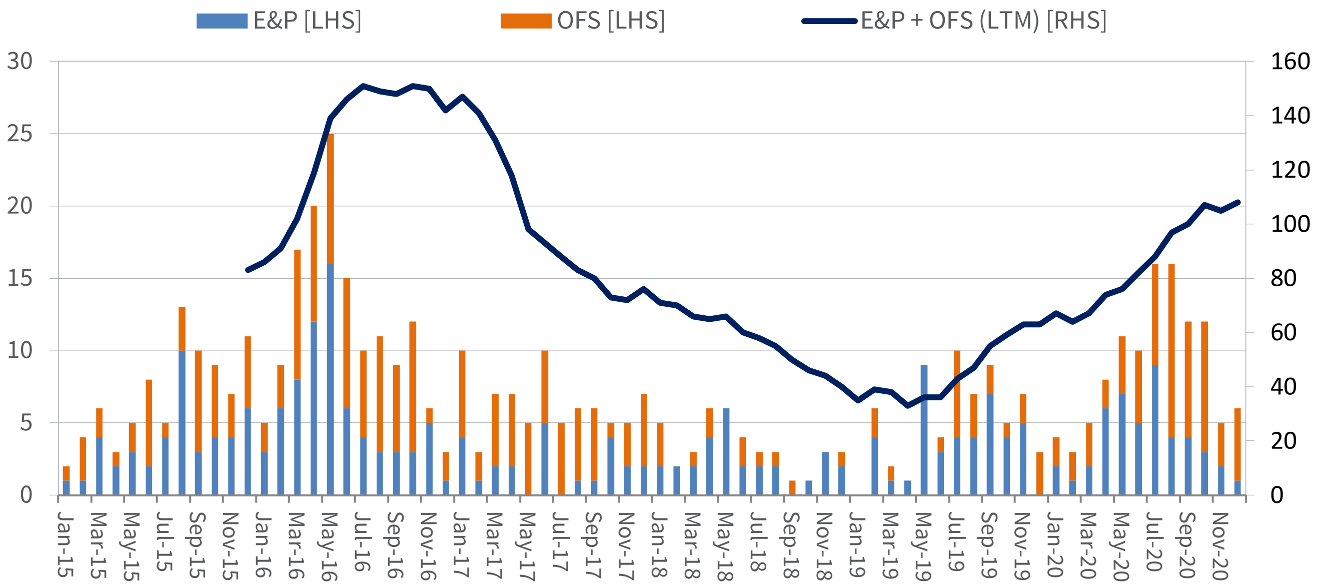
In each instance, the underlying merger transaction featured a stock-for-stock exchange, a modest premium over pre-deal market prices, a significant premium compared to early 2020 valuations and a considerable discount to 2018-2019 valuations — allowing buyers and sellers alike to believe each had struck a good deal. For buyers, the ability to acquire the production, reserves and acreage of established shale oil producers at reasonable prices without using cash as a deal currency is an attractive proposition even in lean times. The accumulation of reserves and acreage by these buyers will provide more efficiencies of scale and allow them to negotiate more favorable business terms from oilfield service providers for well maintenance and new drilling activity.

The new M&A template of non-cash mergers among large producers will likely continue in 2021 and would result in meaningful industry consolidation. This seems to be a workable solution to an intractable problem in the energy sector, and certainly one that makes more sense than the relentless need to drill just to stay even. As more independent E&Ps cut back on new drilling activity to conserve cash and total reserves begin to dwindle, some will find the prospect of a hastily arranged marriage to be their best option. Small independent E&Ps with substantial debt may not even have that luxury. Oilfield service companies will hardly take comfort from these deals and will continue to face business hardship, given the prospect of depressed drilling activity for the foreseeable future and larger clients who will squeeze

them even harder. In turn, this will encourage consolidation activity within the OFS sector in order to regain some desperately needed pricing power.

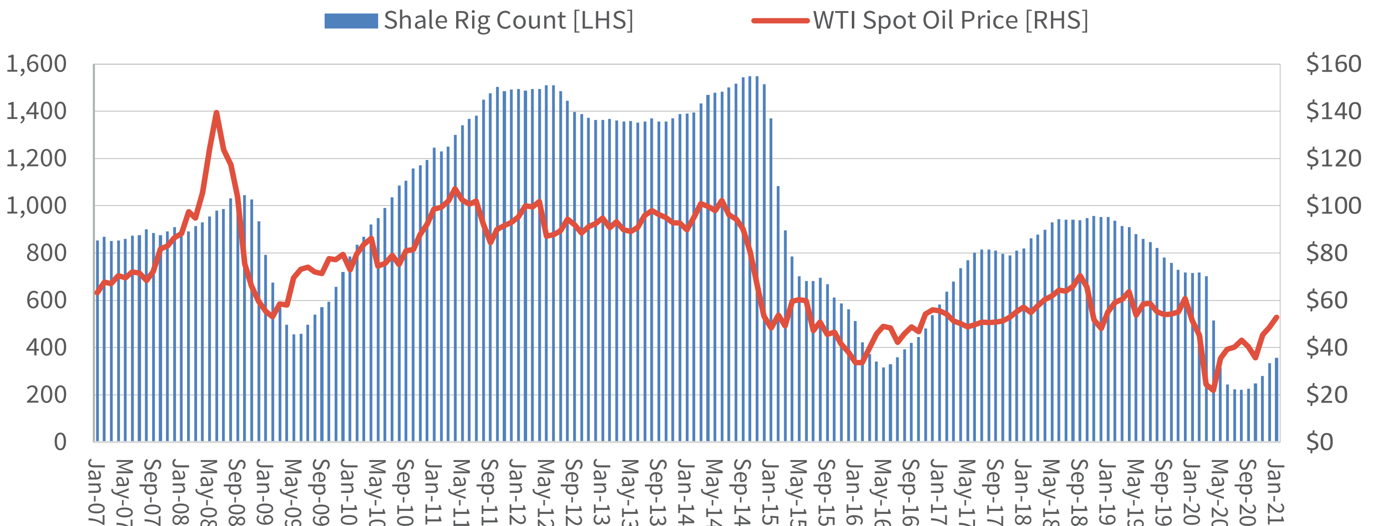
Commodity prices have rallied across the board in early 2021, and that includes the energy complex. Drilling activity has bottomed off the lows of mid-2020, and it should be a time of guarded optimism. However, it doesn't quite feel that way for the energy sector, with pragmatic opportunism now prevailing after many years of unchecked optimism.

Exhibit 1 - Monthly Energy-Related Chapter 11 Filings



Source: Haynes and Boone, LLP

Exhibit 2 - Active Rig Count in Major U.S. Shale Regions



Source: U.S. Energy Information Administration (EIA)

Endnotes

1. Oil Patch Bankruptcy Monitor and Oilfield Services Bankruptcy Tracker, Haynes and Boone, LLP, December 31, 2020
2. Drilling Productivity Report, U.S. Energy Information Administration (EIA), January 2021
3. OFS Bits 2.27—3Q20 Preview: Status Quo 2H20, Focus Shifts to 2021, Scotiabank, October 13, 2020.

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