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August 2019 Energy Market Update

Sightline INSTITUTE

Institute for Energy Economics and Financial Analysis
IEEFA.org

U.S. Fracking Sector Disappoints Yet Again

The Best Showing in Years—yet Cash Flow Remains Weak as Stock Prices Fall

A cross-section of 29 fracking-focused oil and gas companies reported meagre cash returns in the second quarter of 2019.

Only 11 of the 29 companies reported positive free cash flows. All told, these publicly traded firms generated just $26 million in aggregate free cash flows—far too modest to make a significant dent in the more than $100 billion in long-term debt owed by these companies, let alone reward equity investors who have been waiting for a decade for robust and sustainable results.

Yet, as disappointing as these numbers were, they represented the highest quarterly cash flows for oil and gas producers in years.

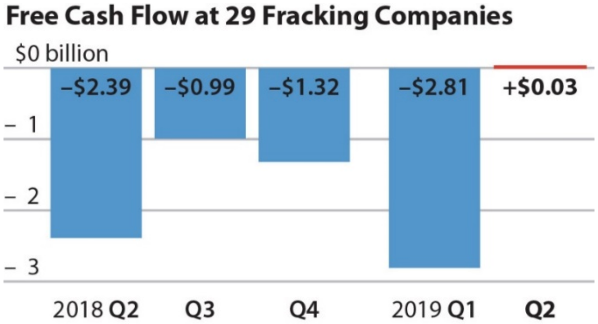
Free cash flow is a crucial gauge of financial health. The free cash flow measure is defined as a company's operating cash flows—the amount of cash generated by its core business—minus capital spending. Positive free cash flows give companies financial resources to pay down debt and reward stockholders. Negative free cash flows, in contrast, force companies to fund their operations by dipping into cash reserves, selling assets, or raising new money from capital markets.

Key Findings

- U.S. fracking-focused oil and gas companies reported a mediocre second quarter.
- A cross-section of small and mid-sized U.S. E&Ps reported a mere $26 million in free cash flows from April through June 2019.
- Disappointing cash flows have soured investors on the sector, constraining the oil and gas industry's ability to tap debt and equity markets.

Last quarter's cash performance—just a hair over breaking even—would count as a bitter disappointment in virtually any other sector of the economy. But for an industry that has posted negative cash flows for a decade, these mediocre results represent a financial high-water mark.

Free Cash Flow at 29 Fracking Companies



Sources: Morningstar; company reports

Even so, stock market investors have continued to punish the sector. Over the past three months, a leading ETF (exchange traded fund) for oil and gas producers fell more than 26 percent, even as the broader Standard & Poor's 500 index rose by nearly 3 percent.[1] Clearly, investors are losing faith in the industry after decades of cash losses.

Moreover, this quarter's relatively strong results can be traced to a single company, EOG Resources, which posted $1.1 billion in free cash flow for the quarter, a turnaround of $1.5 billion quarter-over-quarter. EOG's results were assisted by a $437 million decline in the company's capital spending. Without EOG's outperformance, our sample of frackers would have remained resolutely cash-flow negative. Other companies with positive free cash flows included Marathon Oil ($150 million), Devon Energy ($116 million), and Cabot Oil and Gas ($101 million). On the downside, marquee names in the fracking sector posted negative free cash flows, including Anadarko Petroleum (-$526 million), Southwestern Energy (-$227 million), Chesapeake Energy (-$178 million), and Diamondback Energy (-$154 million).

At the close of Q2, the oil and gas sector was near the bottom of the S&P 500. By August 15, 2019 the sector hit rock bottom, with drilling, exploration and production, and equipment and services leading the decline. Even the positive returns from EOG Resources failed to halt the downward slide in the company's stock price.

"Even positive returns from EOG failed to halt the downward slide in its stock price."

In the early stages of the fracking boom, investors tolerated disappointing results from oil and gas producers, believing that the industry would eventually produce ample cash returns. But shale became a victim of its own success, with abundant oil and gas production keeping prices too low to generate robust profits—as natural gas prices below $2.50/MMBTU this summer clearly demonstrate. A few companies can now eke out modest positive cash flows. Yet the sector as a whole has never produced enough cash to pay down debt or reward investors with generous dividends or share buybacks. To the contrary, oil and gas companies have had to return repeatedly to debt and equity markets for infusions of cash to keep their operations running and the oil and gas flowing.

The 29 companies in our sample represent relatively strong performers among oil and gas production companies. None of these companies declared bankruptcy over the last decade. The larger universe of fracking companies, however, has suffered even worse results over time, as a wave of corporate bankruptcies wiped away billions of additional dollars in debt and equity. Since 2015, 192 North American oil and gas producers have filed for bankruptcy protection, restructuring more than $100 billion in debt, largely through write-offs.[2]

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[1] Market prices for the SPDR S&P Oil & Gas Exploration & Production ETF (XOP) vs. the S&P 500 Index.

[2] Haynes and Boone, LLP. Oil Patch Bankruptcy Monitor. August 12, 2019.

Two factors improved the industry's performance during the second quarter of 2019. First, the U.S. oil price benchmark rose by roughly 9 percent compared with the first quarter of the year. Higher oil prices boosted revenues and operational cash flows, particularly for oil-focused exploration and production companies. However, prices have since moderated, portending lower realizations from oil and gas sales in the third quarter.

Second, the companies in our sample trimmed capital expenditures from $14.9 billion in Q1 to $14.4 billion in Q2. This modest capex cut pushed the sample's cash flows into positive territory.

"The sector has never produced enough cash to pay down debt or reward investors with dividends or buybacks."

Frackers' persistent inability to produce robust cash flows should be of grave concern to investors. A healthy industry would generate enough cash not only to sustain its own capital spending, but also to pay off debt and reward stockholders—all while maintaining or even increasing its output to support rising stock prices. Until fracking companies can demonstrate that they can produce cash as well as hydrocarbons, cautious investors would be wise to view the fracking sector as a speculative enterprise with a weak outlook and an unproven business model.

Data and Methods

This report tracks the financial performance of 29 U.S.-focused oil and gas exploration and production companies. The analysis started with the list of stocks held as components of the SPDR S&P Oil & Gas Exploration & Production ETF (ticker symbol XOP), and then excluded companies that:

- Lack comprehensive income or cash flow data for 2010 through Q2 2019 available through Morningstar;
- Declared bankruptcy at some point between 2010 and Q1 2019; or
- Derive much of their revenues from midstream (transportation) operations, downstream (refining and petrochemicals) operations, or from exploration and production operations outside the U.S.

The final list includes 29 U.S.-focused oil and gas exploration and production companies.

This report relies on financial data downloaded from Morningstar during August of 2019, as well as previous downloads over the preceding two years. For Continental Resources, Anadarko Petroleum, and Denbury Resources, we supplemented the most recent Morningstar data with figures from the company's quarterly SEC 10-Q filings and data downloads from prior quarters.

Note that the list of companies included in the second quarter report does not match up precisely with previous reports in this series. Newfield Exploration was included in previous reports, but was purchased by Encana Corporation and no longer reports independent financial statements. We dropped Murphy Energy for this report, as a review of Morningstar data revealed inconsistencies and potential errors. Oasis Petroleum and Continental Resources were added back into the sample; these two companies had previously been dropped from our sample for data consistency reasons that have since been resolved.

Free Cash Flow, Selected E&Ps (Million U.S. Dollars)

Company	Stock Symbol	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019
Apache Corporation	APA	96	64	(25)	(265)	53
Anadarko Petroleum Corporation	APC	(505)	33	335	(260)	(526)
Antero Resources Corporation	AR	(266)	(146)	287	67	(124)
Chesapeake Energy Corporation	CHK	(232)	(57)	(126)	(74)	(178)
Continental Resources	CLR	11	98	175	(32)	(21)
Cabot Oil & Gas Corporation	COG	43	(18)	69	390	101
Callon Petroleum Company	CPE	(79)	(41)	(4)	(119)	(16)
Carrizo Oil & Gas	CRZO	(59)	(64)	(301)	(46)	(15)
Concho Resources	CXO	124	(85)	(198)	(282)	(97)
Denbury Resources	DNR	68	60	20	(24)	54
Devon Energy	DVN	(48)	236	(78)	(182)	116
EOG Resources	EOG	258	540	783	(393)	1,124
EQT Corporation	EQT	(327)	(257)	(346)	500	49
Diamondback Energy	FANG	(192)	(173)	(1,407)	(411)	(154)
Hess Corporation	HES	(68)	(117)	217	(433)	51
Laredo Petroleum	LPI	(50)	(37)	(25)	(78)	45
Marathon Oil Corporation	MRO	129	194	171	(100)	150
Matador Resources Company	MTDR	(162)	(563)	(106)	(157)	(65)
Noble Energy	NBL	(499)	(110)	(130)	(235)	(78)
Oasis Petroleum	OAS	22	(77)	(74)	(63)	(74)
PDC Energy	PDCE	(62)	(58)	45	(90)	(25)
Pioneer Natural Resources Co.	PXD	64	(104)	(187)	(209)	(43)
QEP Resources	QEP	(186)	27	(78)	(87)	(36)
Range Resources Corporation	RRC	(113)	20	26	47	(14)
SM Energy Company	SM	(275)	(80)	(100)	(131)	(67)
Southwestern Energy Company	SWN	(82)	(17)	(30)	184	(227)
Whiting Petroleum Corporation	WLL					

		99	(67)	48	(47)	(9)
WPX Energy	**WPX**	(56)	(129)	(232)	(179)	39
Cimarex Energy Company	**XEC**	(43)	(66)	(50)	(100)	13
Total, selected E&Ps		**(2,390)**	**(994)**	**(1,321)**	**(2,809)**	**26**

About IEEFA

The Institute for Energy Economics and Financial Analysis conducts research and analyses on financial and economic issues related to energy and the environment. The Institute's mission is to accelerate the transition to a diverse, sustainable and profitable energy economy. www.ieefa.org

About the Authors

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Clark Williams-Derry, Director of Energy Finance for Sightline Institute, researches U.S. and global energy markets, particularly in the Western U.S. and Canada. Williams-Derry's recent research has covered the finances of the Dakota Access Pipeline and the proposed Trans Mountain pipeline expansion; liquefied natural gas projects in British Columbia; "self-bonding" for coal mine reclamation; West Coast coal export projects; greenhouse gas accounting for coal export projects; coal industry bankruptcies and the interactions between federal coal leasing policy and coal exports.

Tom Sanzillo

Tom Sanzillo, director of finance for IEEFA, is the author of several studies on coal plants, rate impacts, credit analyses and public and private financial structures for the coal industry. He has testified as an expert witness, taught energy-industry finance training sessions, and is quoted frequently by the media. Sanzillo has 17 years of experience with the City and the State of New York in various senior financial and policy management positions. He is a former first deputy comptroller for the State of New York, where he oversaw the finances of 1,300 units of local government, the annual management of 44,000 government contracts, and where he had oversight of over $200 billion in state and local municipal bond programs and a $156 billion pension fund.

Kathy Hipple

Kathy Hipple, a financial analyst at IEEFA, teaches the finance sequence at Bard's MBA in Sustainability and is the founding partner of Noosphere Marketing. Hipple has written extensively about sustainable, responsible and impact finance and investing. As Vice President at Merrill Lynch for 10 years, she placed fixed income securities with international institutional clients, and advised international life insurance companies and pension funds. She later founded Ambassador Media, a local search firm in New York City, and served as its CEO. She has served on several boards, including the national Local Search Association and Bennington County's Meals on Wheels.