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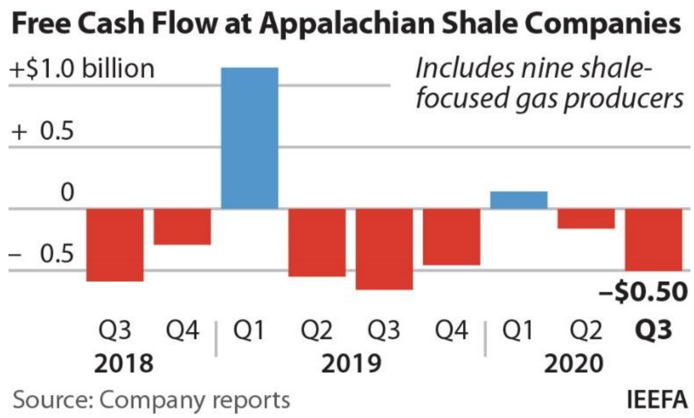
Despite Drastic CapEx Cuts, Appalachian Frackers Spill Red Ink in Third Quarter—Again

Nine Shale-Focused Producers Report Cumulative $504 Million Negative Free Cash Flow

An IEEFA analysis reveals that nine shale-focused gas producers in Appalachia slashed their capital expenditures (capex) in the third quarter by more than one-third compared to the prior year. Despite the cuts, the nine companies spent $504 million more on drilling and other capital projects during the quarter than they generated by selling oil and gas, with six companies reporting negative free cash flows.



These results follow a dismal decade for the Appalachian frackers, culminating in bankruptcies for two key players.[1] Gulfport Energy filed for bankruptcy protection in November. Chesapeake Energy, which had filed for bankruptcy earlier in the year, is currently restructuring its $7 billion debt.

All told, the nine companies in IEEFA's sample made $1.8 billion in capital expenditures for the quarter—a 34% year-on-year drop, and the lowest quarterly total in more than six years (See Table 1).

Eight of the nine companies in the IEEFA sample slashed capital spending from the prior year's level. Range Resources, for example, cut its quarterly capex to $72 million, down from $178 million in the third quarter of 2019. Despite bullish statements from executives, EQT slashed its quarterly capex through the third quarter by more

Key Findings

- Nine fracking-focused gas companies in Appalachia reported $504 million negative free cash flow in Q3 2020.
- In aggregate, capital spending was $1.8 billion in the quarter, a 34% year-on-year drop.
- Capital investments during the quarter were the lowest in at least six years.
- Hedging provided significant sources of cash.

[1] IEEFA. In Extremis: Crisis Mounts for Appalachian Shale Producers. March 2020.

than 40% compared to the prior year. Only National Fuel increased its capital spending in the quarter, primarily as a result of acquiring Shell's dry gas assets in July.

In an ominous sign for the region's gas industry, Chevron and Shell have walked away from their shale gas assets in Appalachia. Chevron sold its Appalachian gas properties to EQT for $735 million, "pennies on the dollar" compared to their original purchase price.[2] Chevron had taken a $10.4 billion asset write-down in the fourth quarter of 2019,[3] more than half of which was related to its Appalachian gas assets.[4]

Similarly, in May Shell sold its remaining Appalachian gas assets for more than $541 million to National Fuel Gas in a transaction described as a "fire sale."[5] Shell had acquired these assets, including more than 400,000 acres in Pennsylvania, as part of a $4.7 billion deal in 2010.[6] Shell had taken steep impairments on its North American shale properties during the second quarter.[7]

ExxonMobil has also soured on its North American dry gas assets, including those in Appalachia, recently announcing that it would not move forward with development plans of some of its global gas assets, and acknowledging it would incur an after-tax impairment of between $17 billion and $20 billion in the fourth quarter.[8] The oil giant acquired most of its North American dry gas assets in its $35 billion acquisition of XTO in 2010, when gas prices were double or triple today's prices. Exxon has already written off $2 billion of the acquisition to date, and in 2019, Rex Tillerson, ExxonMobil's then-CEO who oversaw the purchase, admitted the company had paid too high a price.

Although Henry Hub natural gas prices rose from $1.71 per million British thermal units (MMBtu) to $2.00/MMBtu during the third quarter,[9] Appalachian gas is often priced at the Dominion South hub, which typically trails Henry Hub prices. Over the past month, for example, pipeline constraints between Appalachia and the Gulf Coast tipped Dominion South prices down to $1.44/MMBtu, far below Henry Hub prices.[10]

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[2] Marcellus Drilling News. Sources: EQT Offering $750M for Chevron's Marcellus/Utica Assets. September 17, 2020
[3] Chevron. 2019 Form 10-K. February 10, 2020.
[4] S&P Global. Chevron to take $10B write-down on US shale-related assets, mulls divestitures. December 10, 2019.
[5] MarcellusDrillingNews. Fire Sale: Shell Sells All Remaining PA M-U Assets for $541M. May 5, 2020. Also see: National Fuel. National Fuel to Acquire Shell's Integrated Upstream and Midstream Assets in Pennsylvania. May 4, 2020.
[6] Oil & Gas Journal. Shell to Buy East Resources for $4.7 billion. May 28, 2010.
[7] Shell. Second Quarter 2020 Update Note. July 30, 2020. Also see: Shell. 2nd Quarter 2020 and Half Year Unaudited Results. July 30, 2020.
[8] ExxonMobil. ExxonMobil to prioritize capital investments on high-value assets. November 30, 2020.
[9] U.S. Energy Information Administration. Henry Hub Natural Gas Spot Price. December 2020.
[10] S&P Global. ANALYSIS: As Henry Hub Rallies, Growing Market Dislocation Leaves Appalachian Basin Behind. October 26, 2020.

Several Appalachian shale producers continued to use financial hedging strategies to soften the blow of low prices. EQT, for example, netted $252 million from commodity derivatives in the quarter and more than $800 million through the third quarter of 2020.[11] Company executives believe that hedges insulated the company from weak gas prices, and intend to increase hedging in the future.[12]

Despite modest price gains, Appalachian gas producers continued to shut in production during the quarter. EQT announced it would curtail gas output in September, after similar cutbacks in May and in July. Cabot Oil and Gas announced in October that it would shut in one-third of its production.[13] In their quarterly earnings calls, several other Appalachian producers, such as CNX,[14] signaled cuts in short-term output, awaiting higher margins and relief from today's supply glut. But relief may be slow in coming: In its most recent forecast, the U.S. Energy Information Administration (EIA) projected that U.S. 2020 gas consumption would decline by nearly 2 percent year over year, and fall another 5 percent in 2021.[15]

As production cuts lifted gas prices from their June lows, some gas-focused fracking companies saw a modest boost in stock prices. EQT's stock, for example, increased from $11.44 on July 1 to $12.93 on September 20, a 13% increase. Yet substantial stock market gains would be needed for the companies to restore the value lost over the last decade. The market capitalization of Range Resources, for example, plummeted almost 90% over the last five years, dropping from more than $15 billion in 2015 to its current $1.6 billion at the end of September 2020. Even EQT, which acquired Chevron's assets and is said to be considering acquiring Appalachian producer CNX, saw its market cap drop 73% over the past five years, from $12.5 billion in 2014 to $3.4 billion at the end of the quarter.

The shale revolution has turned the U.S. into the world's most prolific gas producer. Yet in financial terms, the gas production boom has been an unmitigated financial bust, with most fracking-focused companies, including major Appalachian gas companies, regularly reporting negative free cash flows. Free cash flow—the amount of cash generated by a company's core business, minus its capital spending—is a crucial gauge of financial health. Positive free cash flows enable firms to pay down debt and reward stockholders. Negative free cash flows, by contrast, force companies to fund their operations by dipping into cash reserves, selling assets, or raising new money from capital markets.

Negative free cash flows have made debt repayment an ongoing challenge for Appalachian gas producers. At least 13 Appalachian gas producers have filed for bankruptcy protection over the past five years.[16]

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[11] EQT. EQT Reports Third Quarter 2020 Results. October 22, 2020.
[12] Pittsburgh Business Times. EQT cutting back on natural gas production. September 10, 2020.
[13] Cabot. Cabot Oil & Gas Corporation Provides Operational Update. October 7 2020.
[14] Seeking Alpha. CNX Resources Corporation (CNX) CEO Nick Deiuliis on Q2 2020 Results – Earnings Call Transcript. July 30, 2020.
[15] U.S. Energy Information Administration. Short-term Energy Outlook. November 10, 2020.
[16] The 13 shale producers focused on Appalachia that filed for bankruptcy between 2015 and 2020 are: Magnum Hunter (2015); Warren Resources, Penn Virginia, Stone Energy, and Ultra Petroleum (2016); Ascent Resources, Rex Energy, EV Energy Partners, and EXCO (2018);

Moving forward, Appalachia's gas industry may attempt shore up its cash performance by restraining capital spending and by using hedging strategies to cushion itself from volatile prices. Some companies may sell off long-term royalty interests to raise short-term cash. Yet these moves would simply reinforce the sector's pessimistic outlook. As EQT's chief executive said in its most recent investor conference call, "Based on the current price environment, we expect to run this business at a maintenance level for the next several years."[17] Without a sustained price rebound and renewed capital investments, market watchers can expect Appalachian gas producers to continue to shrink, both in their gas output and in their financial health.

Table 1: Free Cash Flows, Q32019-Q3 2020, in millions

Company Name	Eikon ticker	Mstar ticker	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20
FREE CASH FLOW: US CURRENCY							
Antero Resources Corporation	AR	AR	(94)	(168)	(111)	(148)	25
Cabot Oil & Gas Corporation	COG	COG	72	95	56	(46)	(18)
Chesapeake Energy	CHK	CHK	(264)	(124)	(121)	27	276
CNX Resources	CNX	CNX	(31)	(114)	115	9	115
EQT Corporation	EQT	EQT	(173)	(127)	244	191	(92)
Gulfport Energy Corporation	GPOR.o	GPOR	79	33	17	(45)	(110)
National Fuel Gas	NFG	NFG	(78)	(31)	26	50	(527)
Range Resources Corporation	RRC	RRC	(74)	(25)	(17)	(50)	(97)
Southwestern Energy Company	SWN	SWN	(95)	3	(68)	(150)	(75)
Total			**(657)**	**(457)**	**141**	**(161)**	**(504)**

EdgeMarc, Arsenal Resources (2018), Chesapeake Energy (2020), and Gulfport Energy (2020), based on several reports in Marcellus Drilling between 2105 and 2020.
[17] Fool.com. EQT Corp (EQT) Q2 Earnings Call Transcript. July 27, 2020.

About IEEFA

The Institute for Energy Economics and Financial Analysis (IEEFA) examines issues related to energy markets, trends and policies. The Institute's mission is to accelerate the transition to a diverse, sustainable and profitable energy economy. www.ieefa.org

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Tom Sanzillo, Director of Financial Analysis for IEEFA, is the author of numerous studies on the oil, gas, petrochemical and coal sectors in the U.S. and internationally, including company and credit analyses, facility development, oil and gas reserves, stock and commodity market analysis and public and private financial structures. Sanzillo has experience in public policy and has testified as an expert witness, taught energy industry finance and is quoted frequently in the media. He has 17 years of experience with the City and the State of New York in senior financial and policy management positions. As the first deputy comptroller for the State of New York Sanzillo oversaw the finances of 1,300 units of local government, the annual management of 44,000 government contracts, and over $200 billion in state and local municipal bond programs as well as a $156 billion global pension fund.