

Short-Term Pessimism for Gas

John Donnelly, JPT Editor • jdonnelly@spe.org



Chevron's decision last month to put its North American land-based natural gas drilling on hold highlights not only how tough things have become for drillers but also this year's divergence in oil and gas prices. Chevron cited poor demand and said it does not make sense to continue drilling and producing gas at depressed prices. Other operators and service companies also were pessimistic about the outlook for gas drilling for the rest of this year when announcing second quarter earnings.

Gas prices in the US are at about a fourth of their value compared with a year ago. Oil prices have rebounded to half of their highs from last year, but the gas market finds itself hampered by new competing supplies from un conventionals, pipeline constraints, and built-in barriers to trade that oil does not face.

In addition to poor demand caused by the recession, drillers are a victim of their own success. The growth of new unconventional gas-shale resources has created a significant oversupply that has helped beat down gas prices. Shale development has become prolific—at Barnett in Texas, Haynesville in Louisiana, and Marcellus in Pennsylvania, among others. Unconventional gas supplies seem to be gradually displacing conventional gas production in the US, a pattern that could be repeated in many parts of the world. Recently, energy companies in Europe have begun to turn more to un conventionals in light of maturing gas fields and concerns of dependence on Russian gas supplies.

Finding and development costs for unconventional production have fallen, and technology advancements have greatly improved unconventional development prospects. Unconventional gas production has been growing sharply since 1990, even as conventional offshore and onshore gas output has declined. In addition, last year's high gas prices led to stepped up drilling, efforts paying off this year in increased production.

Gas is not as tradable or as "moveable" as oil, which is part of the reason efforts to form a global gas cartel, similar to OPEC, have not gotten far. In the US, there is often a disconnect among new gas supplies, gas demand centers, and pipeline infrastructure or capacity. That makes gas prices regionalized, unlike oil, which limits trade that would naturally follow supply and demand signals.

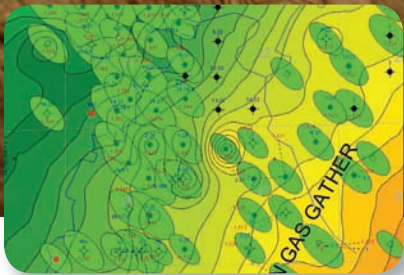
The increasing efficiency in gas-shale development and the exciting new prospects have encouraged some operators to continue drilling this year, including Chesapeake Energy and Anadarko. Early results from the Marcellus-shale development—it is estimated to contain 3 billion to 6 billion cubic feet of recoverable gas—have led Anadarko to believe that it could be a star in its onshore portfolio.

The short-term outlook for gas prices is not good, despite what oil prices do. Gas-shale producers are likely to keep drilling. And new liquefied natural gas imports, not to mention new promising Canadian production such as Horn River, should only add pressure on gas.

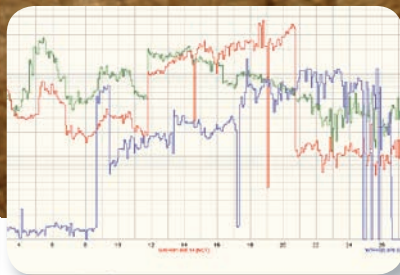
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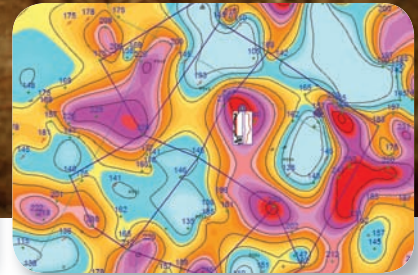
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