US producers run low on energy to beat recession

News analysis

A drop in prices has led to revenue cuts and rising bankruptcies, says Sheila McNulty

When oil and natural gas prices dropped sharply at the end of last year, Swift Energy found itself with 60-70 per cent less revenue over a period of only a few months.

Bruce Vincent, president of the small exploration and production company, has been scrambling to cut costs: "We can't do it as fast as the price drops."

Swift's strong balance sheet has helped mitigate the impact. But Mr Vincent was forced to begin 2009 with a 75 per cent cut in capital spending plans. He stopped drilling in some areas and laid off 11 per cent of his staff – 40 people.

"It's hard to do on a human level," Mr Vincent says. "It's really gut wrenching."

He is not alone in feeling the impact of falling commodity prices, the credit squeeze and economic downturn. With even big names, such as ConocoPhillips and Schlumberger, forced to lay off staff and scale back, it is no surprise many of the small, independent producers, which drill 90 per cent of US wells, are in real trouble.

In recent months, there have been eight announcements of forced sales, bankruptcy filings and notices of possible filings, with the most recent warning coming from Edge Petroleum in March.

These are not immaterial companies: 56 per cent of US natural gas and 59 per cent of US oil is produced from companies with fewer than 20 employees, according to the Independent Petroleum Association of America, which has 5,000 members.

"While most of us think about the industry as 'Big Oil', the reality is that the majority of American oil production is produced by small businesses," says Barry Russell, president of the Independent Petroleum Association of America. "These companies may not be well-known, but we are the safety net from increased reliance on foreign oil."

And they are laying down their drilling rigs at an alarming rate, according to Richard Mason, publisher of the Land Rig Newsletter.

The number of land rigs operating in the US has fallen by 1,000, or 48 per cent, since the October 2008 peak, he said – the steepest drop, on a percentage basis, since the 1980s oil crisis.

"We have seen 20,000 employees disappear in the last 90 days," Mr Mason said.

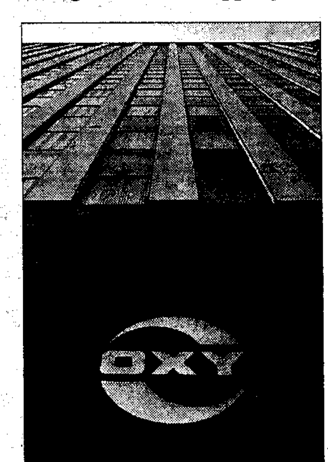
Texas, which produces nearly one third of US natural gas, and employs almost half the workers in the US oil and gas extraction industry, has just gone into recession.

The Federal Reserve Bank of Dallas has attributed the slowdown to the deepening global financial crisis, as well as declines in energy prices, high-tech activity and exports.

"As drilling activity slows, layoffs are becoming widespread in the energy industry and are expected to grow in 2009," the Federal Reserve said.

Against this backdrop, 50 chief executives with the 400-member Independent Petroleum Association of Mountain States campaigned in Washington this month against proposed tax increases for the industry.

The association warned the government of the devastating effect of scrapping tax breaks for the industry, particularly on the small companies doing most US drilling and production: companies including Great Western Oil & Gas, GMT Exploration, Black Hills Exploration & Production and Mesa Energy Partners.



Occidental's chief said producers took on more debt

"These tax breaks are so we drill and not pay the tax man," said Association member Jerry McHugh, chief executive of San Juan Resources, which has an interest in more than 100 wells. The global downturn already has made drilling difficult without tax increases: "I had four wells I was going to drill and operate last year that I had to pull the plug on."

Stephen Chazen, president and chief financial officer of Occidental Petroleum, a low debt business, says that companies assumed the high oil prices of last year would remain high and took on more debt than usual.

The oil price rose to a record $147 a barrel last year before falling to this year's $40-$50 range, and natural gas prices rose to more than $13 per million British thermal units before falling to below $4.

Mr Chazen said the assumption that the high oil price would defy the usual cycle would make a recovery more difficult. "People somehow convinced themselves this time was different," he said.

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Smaller companies bracing themselves for crippling tax increases

Small oil groups are braced for crippling tax increases set to be imposed by the Obama administration's attempts to fund its $3,000bn budget, **writes Sheila McNulty in Houston.**

The administration intends to tap the oil and gas industry, raising $31bn over the next decade by cutting tax breaks. The industry is an obvious target following billions in profits for major oil companies such as ExxonMobil and Chevron.

Ken Salazar, secretary of the interior, said the federal government received one of the world's lowest shares of revenue for oil and gas resources and must re-examine how the federal government is compensated for extraction on its lands.

"That means we are going to take another look at royalty rates," Mr Salazar said. "It means that tax breaks that are no longer needed – and which the American people can't afford – will disappear."

The industry fears the tax increases will damage the small companies producing most US oil and gas, undermining energy independence and security.

The president's draft budget would also repeal expense allowances on intangible drilling costs – similar to those given to other manufacturing and production industries.

According to the Independent Petroleum Association of Mountain States, without such allowances, the US natural gas industry could be "crippled overnight" and capital normally reinvested in US energy reduced by 30-50 per cent.

Larry Nichols, chief executive of Devon Energy, an independent oil and gas producer, warns that oil companies with fewer than 20 employees – they produce 56 per cent of US natural gas and 59 per cent of oil – will bear the brunt when they can least afford to. "They're desperate for money," he says.