Prudence needed in shale boom investments

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The shale revolution continues to drive unprecedented increases in U.S. oil and gas production. In fact, the U.S. could very well become the largest producer of crude oil in the entire world in the foreseeable future, even surpassing Saudi Arabia and Russia. The continued success of exploration and production (E&P) companies in extracting oil and gas from U.S. shale formations is creating unprecedented economic opportunities and attracting a tremendous amount of capital investment, as industry participants pursue a once-in-a lifetime opportunity. These capital commitments are coming not only from E&P companies, but also from midstream companies and others who supply the infrastructure needed to produce oil and gas and bring the output to market.

Opportunities carry risks

While the investment opportunities created by the shale boom are unquestionably real and, in many cases, extremely attractive, it also should be recognized that there are some risks and uncertainties surrounding the shale revolution which should be given consideration by E&P companies and midstream/infrastructure companies, alike. For example, estimates of future production levels, well depletion rates and costs to extract oil and gas from various shale formations vary quite widely. In addition, the productivity of wells in certain parts of the various shale formations can vary widely. In the Utica Shale play in Ohio, for example, some wells have proven to be extremely productive; other wells, drilled in other parts of the Utica Shale, have proven less attractive for the E&P companies. Finally, long-term pricing trends for oil and gas may also prove to be quite unpredictable. A significant drop in prices could adversely impact the profitability of investments.

Midstream operators should carefully weigh risks vs. anticipated rewards

For E&P companies, these risks are mostly a well-known part of everyday business, although the newness of the shale play does make some of the risks harder to evaluate. On the other hand, for midstream operators, these risks need to be carefully considered and understood before making large scale capital investments. Midstream companies will want to carefully consider future production forecasts for the specific localities that they plan to serve. They will also want to be alert to potential overbuilding of infrastructure or creation of over-capacity situations. They will want to assess the financial viability of their customers and the customers' ability to follow-through on commitments if production turns out to be less than expected or if prices turn out to be low, resulting in curtailed production and reduced demand for the midstream services.

Midstream operators should look for ways to reduce some of these risks through means such as appropriate protections in commercial contracts with their customers, careful monitoring of local capacity levels vs. local demand, and by matching their investments closely to those of their customers. Midstream companies may also wish to consider entering into long-term financial hedges to help offset and alleviate certain risks, such as those associated with drops in oil and gas prices.

The shale revolution is creating tremendous economic opportunities and attracting huge levels of new capital investment, and it appears that the shale boom will continue for many years into the future. Industry participants should not, however, throw caution to the wind and make significant capital commitments without having carefully considered the risks involved and the availability of protections of one form or another to help alleviate those risks. As always, prudence is required in making any investment decisions.