

# Shale Fracking is a “Ponzi Scheme” ... “This Decade’s Version of the Dotcom Bubble”

It has “a lot in Common with the Subprime Mortgage Market Just Before it Melted Down”

By [Washington's Blog](#)

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Theme: [Global Economy](#), [Oil and Energy](#)

## A Losing Bet

In 2011, the New York Times [wrote](#):

“Money is pouring in” from investors even though shale gas is “inherently unprofitable,” an analyst from PNC Wealth Management, an investment company, [wrote to a contractor in a February e-mail](#). “Reminds you of dot-coms.”

“The word in the world of independents is that the shale plays are just giant Ponzi schemes and the economics just do not work,” an analyst from IHS Drilling Data, an energy research company, [wrote in an e-mail on Aug. 28, 2009](#).

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“And now these corporate giants are having an Enron moment,” a retired geologist from a major oil and gas company [wrote in a February e-mail](#) about other companies invested in shale gas.

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Deborah Rogers, a member of the advisory committee of the Federal Reserve Bank of Dallas, [and a] former stockbroker with Merrill Lynch ... showed that wells were petering out faster than expected.

“These wells are depleting so quickly that the operators are in an expensive game of ‘catch-up,’ ” Ms. Rogers wrote in an e-mail on Nov. 17, 2009, to a petroleum geologist in Houston, who wrote back that he agreed.

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A review of more than 9,000 wells, using data from 2003 to 2009, shows that — based on widely used industry assumptions about the market price of gas and the cost of drilling and operating a well — less than 10 percent of the wells had recouped their estimated costs by the time they were seven years old.

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“Looks like crap,” the Schlumberger official wrote about the well’s performance, according to the regulator, “but operator will flip it based on

‘potential’ and make some money on it.”

In 2012, the New York Times [pointed out](#):

The gas rush has ... been a money loser so far for many of the gas exploration companies and their tens of thousands of investors.

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Although the bankers made a lot of money from the deal making and a handful of energy companies made fortunes by exiting at the market’s peak, most of the industry has been bloodied — forced to sell assets, take huge write-offs and shift as many drill rigs as possible from gas exploration to oil, whose price has held up much better.

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Now the gas companies are committed to spending far more to produce gas than they can earn selling it. Their stock prices and debt ratings have been hammered.

Rolling Stone [reported](#) the same year:

Fracking, it turns out, is about producing cheap energy the same way the mortgage crisis was about helping realize the dreams of middle-class homeowners. For Chesapeake, the primary profit in fracking comes not from selling the gas itself, but from buying and flipping the land that contains the gas. The company is now the largest leaseholder in the United States, owning the drilling rights to some 15 million acres – an area more than twice the size of Maryland. McClendon [the CEO of fracking giant Chesapeake] has financed this land grab with junk bonds and complex partnerships and future production deals, creating a highly leveraged, deeply indebted company that has more in common with Enron than ExxonMobil. As McClendon put it in a conference call with Wall Street analysts a few years ago, “I can assure you that buying leases for x and selling them for 5x or 10x is a lot more profitable than trying to produce gas at \$5 or \$6 per million cubic feet.”

According to Arthur Berman, a respected energy consultant in Texas who has spent years studying the industry, Chesapeake and its lesser competitors resemble a Ponzi scheme, overhyping the promise of shale gas in an effort to recoup their huge investments in leases and drilling. When the wells don’t pay off, the firms wind up scrambling to mask their financial troubles with convoluted off-book accounting methods. “This is an industry that is caught in the grip of magical thinking,” Berman says. “In fact, when you look at the level of debt some of these companies are carrying, and the questionable value of their gas reserves, there is a lot in common with the subprime mortgage market just before it melted down.”

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In February, Chesapeake announced that, because of low gas prices, its revenues will fall \$3.5 billion short of its expenses this year.

Jim Quinn [noted](#) last year:

Royal Dutch Shell is one of the biggest corporations in the world, with financial resources greater than 99% of all the organizations on earth. Their CEO [Peter Voser] probably knows a little bit more about oil exploration than the Wall Street systers and CNBC bimbos. His company has poured \$24 billion into shale exploration in the U.S. It has been a huge failure. They have already written off \$2.1 billion. They are trying to sell huge swaths of land in the Eagle Ford area. They are losing money in the shale oil and gas business. If Shell can't make it profitable, who can?

Oil Price [reported](#) in March:

Shell's new boss, Ben van Beurden, said bets on U.S. shale plays haven't worked out for his company.

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"Some of our exploration bets have simply not worked out," Shell's Chief Executive Officer Ben van Beurden [said](#). It was bad management policy to commit close to \$80 billion in capital on its North American portfolio and still lose money. Now, he said, it's time to cut the loss and slash exploration and production investments by 20 percent for 2014.

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Shell's problems say more about the difficulties of shale exploration than they do about the company itself.

The Wall Street Journal [pointed out](#) this April:

These newly public companies are spending more than they make ....

Bloomberg [wrote](#) in May:

Shale debt has almost doubled over the last four years while revenue has gained just 5.6 percent, according to a Bloomberg News analysis of 61 shale drillers. A dozen of those wildcatters are spending at least 10 percent of their sales on interest compared with Exxon Mobil Corp.'s 0.1 percent.

"The list of companies that are financially stressed is considerable," said Benjamin Dell, managing partner of Kimmeridge Energy, a New York-based alternative asset manager focused on energy. "Not everyone is going to survive. We've seen it before."

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In a measure of the shale industry's financial burden, debt hit \$163.6 billion in the first quarter, according to company records compiled by Bloomberg on 61 exploration and production companies that target oil and natural gas trapped in deep underground layers of rock.

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Drillers are caught in a bind. They must keep borrowing to pay for exploration needed to offset the steep production declines typical of shale wells. At the same time, investors have been pushing companies to cut back. Spending

tumbled at 26 of the 61 firms examined. For companies that can't afford to keep drilling, less oil coming out means less money coming in, accelerating the financial tailspin.

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"Interest expenses are rising," said Virendra Chauhan, an oil analyst with Energy Aspects in London. "The risk for shale producers is that because of the production decline rates, you constantly have elevated capital expenditures."

And Tim Morgan – former global head of research at Tullett Prebon – [explained](#) last month at the Telegraph:

We now have more than enough data to know what has really happened in America.

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If a huge number of wells come on stream in a short time, you get a lot of initial production. This is exactly what has happened in the US.

The key word here, though, is "initial". The big snag with shale wells is that output falls away very quickly indeed after production begins. Compared with "normal" oil and gas wells, where output typically decreases by 7pc-10pc annually, rates of decline for shale wells are dramatically worse. It is by no means unusual for production from each well to fall by 60pc or more in the first 12 months of operations alone.

Faced with such rates of decline, the only way to keep production rates up (and to keep investors on side) is to drill yet more wells. This puts operators on a "drilling treadmill", which should worry local residents just as much as investors. Net cash flow from US shale has been negative year after year, and some of the industry's biggest names have already walked away.

The seemingly inevitable outcome for the US shale industry is that, once investors wise up, and once the drilling sweet spots have been used, production will slump, probably peaking in 2017-18 and falling precipitously after that. The US is already littered with wells that have been abandoned, often without the site being cleaned up.

Meanwhile, recoverable reserves estimates for the Monterey shale – supposedly the biggest shale liquids play in the US – have been revised downwards by 96pc. [[Background](#) and [here](#); and [see this](#).] In Poland, drilling 30-40 wells has so far produced virtually no worthwhile production.

In the future, shale will be recognised as this decade's version of the dotcom bubble. In the shorter term, it's a counsel of despair as an energy supply squeeze draws ever nearer.

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