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I Have Seen the Future, and It Fracks

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Michael Warren and Donald Luskin

EOG's earnings missed big, but it points the way to a new Moore's Law for energy.

Sometimes a single company stands out as the poster-child for a whole industry, or even an economic paradigm. Such is the case with EOG Resources (NYSE: EOG), the large independent oil and gas explorer and producer, with major shale operations all over North America. *EOG's Q4 2014 results last week speak volumes about how the unconventional domestic producers at the leading edge of the hydraulic fracturing revolution are dealing with the drop in oil prices -- and about how the new technologies they have unleashed have forever transformed price dynamics for the future.*

- Like all its industry peers, EOG's earnings were down big -- $0.79 in Q4 versus $1.31 in Q3, a drop of 60%.
- Why? That's easy. It's because the WTI crude benchmark price fell 58% during Q4.
- Unlike many peers in the same boat who beat estimates that had been marked down sharply, EOG missed big, even though the consensus had fallen from $1.46 to $0.99 over the last three months. The miss may be because prior guidance had failed to account for lost volumes from the sale of Canadian properties.
- In the company's conference call, management announced it is cutting 2015 CAPEX by 40% versus 2014, and expects production to be flat year-over-year.
- Why? That's easy, too. CEO Bill Thomas said -- twice -- that "we do not believe that growing oil in what could turn out to be a short cycle low-price environment is the right thing to do."
- *And that's why we said the cascade in global oil prices that we predicted last June would hit bottom when WTI was in the $40's in January: the marginal producer can't produce at those prices* (see "The Stench of CrISIS" June 25, 2014 and "Oilmageddon: The Sequel" January 15, 2015).
- OEG's forecast for the WTI price over 2014 is an average of $54, ending the year at $65. That's pretty much what we have predicted, too -- a range of $50 to $65.
- *EOG reiterated over and over in the call that it is "ready to respond swiftly when oil prices improve." What's so revolutionary about that is that EOG's response-point isn't all that far above present prices -- in the mid-$60s.*

Update to strategic view

OIL, US RESOURCE STOCKS: Our comparison of the new domestic energy production industry to the semiconductor industry -- crushing prices with exponential improvements in technology -- is more than a metaphor. EOG Resources, in its earnings call last week, stood out as a real-world exemplar of the category, calling its hydraulic fracturing plays "technology laboratories." More profitable now at $65 oil than it was at $95 two years ago, EOG has halted production growth with oil at $50 and below. But it stands ready to ramp up production from uncompleted wells, exercising a "call option" at $65. Thus we see competitive forces that set the floor at $50 and the ceiling at $65, no matter what OPEC does. As productivity improves, the ceiling and the floor both move lower.

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- *<u>Why? Because EOG is a stellar example of a new-technology energy producer that has been dramatically moving down the learning curve and slashing its costs of production.</u>*
- We've likened the unconventional producers to the semiconductor industry, pushing technology to the max in order to fulfill the promise of Moore's Law. EOG sees itself in just those terms: "We often refer to the Eagle Ford as our technology laboratories. Our understanding of this field and how to increase its recovery rate has led to improvements in plays across the entire company."
- Thus "as a result of cost and oil productivity improvements in the Eagle Ford western acreage, we can now generate better returns with $65 oil than we did at $95 just two or three years ago."
- Now, on top of that, in the current downturn EOG says "we have already seen service cost reductions in many areas and see the potential for 10% to 30% vendor savings."
- *<u>No wonder EOG concludes that its hundreds of wells now being left uncompleted means that "The Eagle Ford represents a huge call option on oil that EOG can exercise at any time to take advantage of a favorable oil price environment."</u>*
- The present productivity limits on unconventional production technology put a floor under oil prices near the present price -- *for now* (see "Grant Me $20 Oil, But Not Yet" February 17, 2015). But every day those limits change for the better.
- Today, EOG can exercise its Eagle Ford call option at $65. And you know what happens when there is a large open interest at an option strike-price: the price of the underlying tends to get pinned there. So OEG's call options set a ceiling on prices -- *for now* -- no matter what OPEC does at some hypothetical emergency meeting such as was rumored yesterday. As OEG and others move down the learning curve, that strike-price just gets lower and lower.
- This is why we say that the fundamental pricing paradigm for oil has changed. It is no longer based on scarcity to be rationed by a cartel, but rather based on abundance to be allocated in "perfect competition" (see "Oilmageddon" December 16, 2014).

Bottom line

Our comparison of the new domestic energy production industry to the semiconductor industry -- crushing prices with exponential improvements in technology -- is more than a metaphor. EOG Resources, in its earnings call last week, stood out as a real-world exemplar of the category, calling its hydraulic fracturing plays "technology laboratories." More profitable now at $65 oil than it was at $95 two years ago, EOG has halted production growth with oil at $50 and below. But it stands ready to ramp up production from uncompleted wells, exercising a "call option" at $65. Thus we see competitive forces that set the floor at $50 and the ceiling at $65, no matter what OPEC does. As productivity improves, the ceiling and the floor both move lower.

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