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## Why Is Drilling Activity Frenzied With Natural Gas Prices So Low?

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Vials containing oil extracted from shale are seen in a laboratory in Boston. Drilling technology advances have unlocked enormous domestic gas... [View Enlarged Image](#)

drillers as excitement over shale gas discoveries mounted.

Mineral leases generally require drillers to begin production within a given time or surrender rights.

"You've got to drill it or lose it," said Rodman & Renshaw analyst Jeffrey Hayden.

In a rush to lock up promising acreage, exploration and production outfits signed short leases with conditions that favored sellers. Whereas gas leases typically run five years, many leases in the new shale areas expire after three years if the driller does not begin production. "Many leaseholders simply have to start production in order to extend their leases," said Jason Wangler, analyst with Wunderlich Securities.

This drilling to retain leases — not demand — is flooding the market and suppressing gas prices.

Encana Corp. (ECA) is a major lease holder in the Haynesville Shale in East Texas. The Calgary, Alberta-based natural gas producer is drilling on 250 sections — square miles — simply to retain land, says spokesman Alan Boras. That's 40% of Encana's holdings there.

### Everybody's Doing It

Encana's level of lease-related drilling is not unusual. EOG Resources (EOG) offered the following e-mail response to IBD questions: "The portion of EOG's capital expenditures that has been designated for natural gas drilling in the Haynesville, Marcellus and Horn River is primarily to retain our leasehold acreage positions."

Petrohawk Energy (HK), GMX Resources (GMXR) and Forest Oil (FST) — all with Haynesville holdings — didn't respond to requests for information on their lease-related drilling.

Up to 50% of all industry drilling for natural gas is tied to the need to retain leases, says Chesapeake Energy (CHK) CEO Aubrey McClendon.

Shale discoveries may be the long-term factor suppressing gas prices. But near term, said Rashid, lease retention is "exacerbating the supply-demand imbalance."

The continuing weakness in natural gas prices has become something of a mystery.

A barrel of oil historically costs six to eight times as much as a thousand cubic feet of natural gas. But even after the recent plunge, crude is above \$74. Gas is near \$4.40. So the ratio is around 17.

"Gas is the cheapest it's been in recent memory as compared with oil," said Rehan Rashid, analyst with FBR Capital.

Drilling technology advances have unlocked enormous domestic gas reserves trapped in shale, swelling supply even as demand weakened during the recession. This explains last year's prices, but not today's.

Drillers tend to cut back when prices are low. That's what they did last year. But in recent months, the rig count has been rising. There are now 953 rotary gas rigs in use in North America, according to Baker Hughes (BHI). That's up 31% from a year ago.

So what explains this manic activity amid depressed prices?

The answer lies in real estate — or in the terms of leases bought by

"Land retention" drilling — as it is sometimes called — is a factor in several areas, including the Marcellus Shale in Pennsylvania and the Eagle Ford Shale in South Texas. It's most prominent in the Haynesville Shale, stretching from East Texas to northwest Louisiana.

When drillers realized several years ago that abundant recoverable gas was there, they began to scoop up land at rising prices.

But many Texas landholders know the oil and gas game. Drillers, said analyst Rashid, often "agreed to unfavorable terms."

Three-year deals — "most of the leases of that vintage," according to Rashid — are why companies already are drilling on leases signed in 2007 and 2008.

### **To Drill Or Not To Drill**

Landholders also insisted on another lease term that has fed into the current drilling. Whereas in some areas companies can extend a lease simply by drilling a single shallow well, many Haynesville leases bar that. "The leases might say you can't hold a deep zone with a shallow well," said Hayden.

Exploration and production outfits are in a quandary. "On the one hand you don't want to drill because prices are low. On the other hand, you need to drill," said Wunderlich's Wangler.

A new Haynesville well can cost \$8 million to 10 million, Rashid estimates. That's a fair sum of change for smaller, cash-hungry outfits in a capital-intense industry.

And drilling now may not be profitable at current prices. Still, drillers that want to protect long-term assets are often choosing to spend rather than forfeit or renew leases.

Prices are of vital interest to utilities with gas-fired plants, as well as to consumers who use it to heat their homes. It's also an urgent issue to investors who have gone long or short on gas via futures, options, ETFs and other instruments.

So how long can the current dynamic hold prices down? Some analysts expect lease-related drilling to continue through mid-2011. But gas prices could begin to rise significantly before then, says Robert Turnham, president of Goodrich Petroleum. Wells are far less productive in their second year. So the volume of gas coming to market from such drilling will drop, he says.

It takes a 1,500-horsepower rig to drill in the Haynesville Shale, he adds. But such rigs have a 95% utilization rate. So the level of drilling can't rise much further.

With these supply constraints, Turnham expects a significant rise in gas prices from current depressed levels. "You're likely to see \$6 by the end of the year," he said.