

# Shale gas: government regulation may dampen major players' interest

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Due to technological advances in the recovery process, shale gas, typically the arena of smaller energy firms, is set to benefit from the rising interest and giant budgets of major oil companies. However, poor market fundamentals will pose a challenge over the short term, and the threat of tightening US federal regulation could derail recent deals and significantly curtail expansion in the future.

Major oil companies are continuing to increase their exposure to shale gas, despite the market's unfavorable conditions. Billions of dollars have been spent in the last few years in both the US and overseas, as technological advances have made the exploitation of previously unrecoverable unconventional gas reserves possible. Deals like BG Group's \$1.3 billion joint venture with Exco Resources, BP's \$1.75 billion purchase of shale interests from Chesapeake Energy, and ExxonMobil's \$41 billion acquisition of XTO Energy (creating the biggest US gas producer and holder of reserves) highlight the positive long-term outlook that energy firms hold towards the role of natural gas in the global energy mix.

According to BP's chief executive, Tony Hayward, speaking from this year's Davos economic summit, this unconventional gas "probably transforms the US energy outlook for the next 100 years". The Obama Administration has also moved to back shale gas through the US-China Shale Gas Resource Initiative, aimed at reducing CO2 emissions and enhancing security of supply through the US' sharing of expertise to help develop Chinese shale gas.

Yet, these developments come at a time when the natural gas market is suffering from deep imbalances: muted global demand in the aftermath of the economic downturn; the prolonged supply glut faced by Europe; sharply rising capacity in liquefied natural gas; and prices that are hovering some 60% below the 2008 highs. Perhaps most significant is the boom in US production brought about by advances in horizontal drilling and hydraulic fracturing, or 'fracking'. With this, the energy landscape of the US has been revolutionized by shale gas production (which makes up roughly 10% of total US production of dry gas), which surged by 71% in 2008 over the previous year.

Despite this, global energy demand is expected to rise by 40% during the next two decades, and energy firms are eyeing unconventional shale plays, not only in the US but in countries such as Germany, Sweden, Poland, China, Australia, India and South America. Furthermore, companies have not been particularly deterred by the weak price environment, as most shale gas developments are still profitable, at around \$3.20 per million British thermal units. Ultimately, recent deals have seen energy firms taking advantage of cheap asset prices, while positioning themselves in what may turn out to be a crucial "game changing" bridge fuel.

There will nonetheless be numerous obstacles along the way for this unconventional energy source. Foremost is the controversy surrounding fracking: the pressurized injection of water mixed with sand and chemicals a mile or more underground. Public opposition is growing, as local communities claim that drilling is polluting groundwater supplies, with one project in the New York watershed abandoned due to political pressure and fears over the potential contamination of the water supply of nine million New Yorkers. However, establishing a direct link between fracking and water pollution has proven difficult, largely due to the fact that energy companies are not required to reveal the chemical content of fracking fluids. The latter is a direct result of the energy industry's exemption (known as the Haliburton Loophole, passed in the Bush Administration's Energy Policy Act of 2005) from the Safe Drinking Water Act and the

Clean Water Act. In addition, because fracking remains regulated only at state level, scientists and the Environmental Protection Agency argue that they have been unable to adequately investigate contamination cases.

All this could change, however, with the introduction of the Fracturing Responsibility and Awareness of Chemicals Act of 2009 (also known as the Frac Act) which, if passed, would bring fracking within the oversight of the federal government and require companies to reveal the proprietary chemical mixtures used in the production process. Therefore, it is this increased regulation, rather than the current weakness in demand, oversupply of European gas, or uncertainty of prices, that represents the industry's greatest concern, and the biggest potential impediment to expansion in both the US and abroad. Should regulation tighten significantly, this could have long-running consequences for US shale, and derail some of the industry's recent deals, one being the ExxonMobil-XTO merger, which allows for a termination provision should Congress' regulation eventually render fracking, "illegal or commercially impracticable."