CAN WE AVOID DÉJÀ VU IN ENERGY COUNTRY?

Second in a series about energy lending past and present

* * *

Blogger Ed O'Leary learned many hard lessons about energy lending in his time in Oklahoma and Texas decades ago. The price of oil and gas may change, but the basics about loan concentrations and more carry on. His series began last week with "Banking The Oil Field: Looking Back and Looking Forward."

* * *

During the current economic cycle we've become accustomed to thinking of how local business conditions have negatively impacted local and regional economies. The damage has been real. The memories are fresh and vivid.

Yet every few years communities--in some cases entire geographical regions--participate in economic booms. One such boom now approaching historic proportions is the domestic drilling for oil and gas from shale "sands," the subsurface strata consisting of shale rock rich in both fuels.

Technology unleashes wealth

What seems to set this activity apart from prior oil and gas booms is the methodology employed to find the deposits. Shale is dense. For oil and gas to flow, new and different technologies have had to be employed.

• The first and perhaps most dramatic is the manner of drilling.

I recall the talk years ago among my driller customers about new techniques of drilling wells, and the likelihood that one day well bores would "turn corners" under the earth's surface.

That day arrived a few years ago and what that means for shale drilling is this: Instead of running well pipe vertically, it's run horizontally in a pattern that is more or less parallel to the surface. The practical result is that there are much greater opportunities along the surface of the pipe to tap into the productive formations.

For oil and gas to flow, the formations have to have a degree of permeability and porosity. Shale formations are less permeable and porous than most other oil- and gas-bearing strata. So horizontal drilling improves access, though that alone is not enough.

• The second new technology is "fracking"--controversial in some quarters.

This term refers to breaking up the formations and forcing liquids under pressure through the formations to help "move" the oil and gas along. What comes up at the surface is both the oil and gas plus the water and chemicals used to "lubricate" the process.

Fracking isn't a new technique. But in harness with horizontal drilling, this method has resulted in the economic accessibility of enormous volumes of previously inaccessible oil and particularly natural gas.

Yes, there are environmental issues at stake here and they offer considerable promise for ongoing political backlash and citizen concern. But, as noted, the technology isn't new so there is a considerable body of expertise on how to conduct fracking without disturbing the subsurface ecology or the quality of drinking water that is produced from large subsurface aquifers.

When the boom booms for rural America

In the meantime, many largely rural communities are experiencing economic activity from shale-based exploration that was undreamed of only a few years ago.

The benefit comes first in the form of local jobs.

Some of these in time will diminish as the mineral fields are explored and defined. But many will remain. Oil and gas production requires a cadre of workers to bring a constant flow of the product to the surface and on to markets in the population centers of the U.S.

I was told recently that in New Mexico, a relatively poor state economically, the average wage earner makes about

$32,000 a year. The average oil field job nationally pays close to an average of $78,000 a year.

What political or economic development authority can ignore that differential?

Another benefit of long lasting duration is the stream of royalty payments to the owners of the mineral interests that are being produced.

The economic life of oil and gas wells can extend over several years. The buyers of the product pay an economic royalty to the mineral owners. You can think of these being like annuity payments stretching over years and even in some cases for decades. This is real wealth flowing into a community and is available for reinvestment and the development of infrastructure to benefit the local economy and its population.

Parameters of the banking challenge

With this veritable gusher of shale oil and gas comes the more traditional problems for commercial banks of concentrations of credit:

- • Geographic concentration

- • Product type concentration,

- • Collateral concentration

- • A use of funds that tends to emphasize loans, rather than alternate forms of liquidity such as investment securities.

I lived through these concentrations 30 years ago in West Texas.

They were real and we watched them accumulate. But we never thought that the price volatility of the commodity, primarily oil in those days, would be so extreme.

Oil and gas exploration (drilling) tends to be a long-term use of funds in a highly capital intensive industry. How do you protect your bank from a drop in oil price per barrel from $31 to $8 in just seven years?

In hindsight, the oilfield banks could have simply declined to make a large volume of production based loans, thereby

avoiding the concentration of oil related business almost entirely.

However, it's one thing to say "no more" to loans for oil and gas drilling and quite another to run a successful bank as a financial intermediary in a local community between savers and users of funds.

Are lenders asking the right questions?

So some of the problems now facing rural counties in diverse geographies such as Texas, North Dakota, and Pennsylvania are really old and familiar ones.

I wonder how much attention local lenders are paying to figuring out how broad and deep the problems could be if the price of the product were to drop precipitously.

Another line of thinking that should be in the minds of community bankers dealing with this explosion of prosperity is where can the problems arise?

What precipitating event or combination of events, however unlikely they seem today, might upend the often-delicate balance of a community's economic base?

There's simply no substitute for a vivid imagination and some very serious "what if" sorts of exercises among community leaders and bank managers.

Think big picture and also think local

It's hard, at times, to see the connection between the national security interests of the United States on the issue of energy independence and the day-to-day routines of small communities in, say, the relatively desolate areas of the high plains in the Dakotas.

Yet there are fundamental connections with enormous national and international implications for both good and mischievous outcomes in what we're seeing today.

In future columns we'll explore these connections and how the economic future of our country can be profoundly influenced by how well we manage our new found energy opportunities.

Once again, the community banks and bankers are at the leading edge of important and perhaps radical change.

In addition to Ed's first installment of this series, check out our Digital Magazine story, where contributing editor Melanie Scarborough talks with Pennsylvania bankers about banking in boomtowns.

About Ed O'Leary

Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions, working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

Today he works as a consultant and expert witness, and serves as instructor for ABA e-learning courses. You can e-mail him at etoleary@att.net. O'Leary's website can be found at www.etoleary.com.

You can get word about these columns the week they are posted by subscribing to ABA Banking Journal Editors Report e-letter. It's free and takes only a minute to sign up for. Click here.