Oil bust could spur natural gas turnaround in San Juan Basin

By Jens Gould jgould@sfnewmexican.com

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To say times are tough for energy companies in the San Juan Basin would be an understatement.

The market for natural gas is so bad right now that T. Greg Merrion has shut in nearly half of his family-owned company's wells, most located in northwestern New Mexico.

But that could soon change.

If Merrion and key industry analysts are correct, there might be a silver lining in the oil crash caused by the coronavirus pandemic — it could end up helping northwestern New Mexico natural gas producers and even give a lift to state revenue in a time of crisis.

"There is a lot less associated gas coming on the market, and we anticipate that it will have a positive impact on natural gas prices going forward," said Merrion, president of independent producer Merrion Oil and Gas Corp., based in Farmington. "That absolutely would impact us in a positive way."

It might seem a strange time to signal potential good news for any part of the energy industry right now, given the recent unprecedented declines in oil prices caused by the novel coronavirus pandemic.

As the COVID-19 outbreak dried up demand for oil and helped send crude prices tumbling, producers in the Permian Basin have shut in thousands of wells and laid down dozens of drilling rigs. Many of those wells produce natural gas along with oil, so output of this “associated gas” has taken a dive as well.

The potential upside: The drop in natural gas production is bound to reduce the global supply of gas and it could lead to shortages, which would drive up prices and allow companies in the San Juan Basin to increase their production, said Daniel Fine, a longtime energy analyst and oil and gas researcher with New Mexico Tech.

That could help revitalize a part of the state that has been devastated by persistently low gas prices, the shuttering of power plants and now the COVID-19 outbreak.

It also could help boost state revenue, Fine said. A resurgence of gas activity would contribute much less to state coffers than oil-related revenue, but it still would be helpful at a time when revenues have taken a beating from low oil prices and a huge drop in tax revenue caused by the pandemic.

“It would be a revenue revival of gas receipts and royalty to the state,” said Fine, who was a research associate at MIT and a project leader in new energy policy for the state of New Mexico from 2013-16.

Already this year, there has been an increase in natural gas activity in the San Juan Basin. In the first three months of 2020, production there averaged just under 202,000 mcf, or thousand cubic feet, per month. That’s up from an average of around 166,000 mcf per month in 2019, according to the Energy, Minerals and Natural Resource Department.

Other analysts agree there could be a gas recovery coming.

Sarp Ozkan, director of energy analysis at Enverus Market Intelligence, an energy industry data and software company, said a natural gas shortage is in the cards not just because supply will drop, but also because the pandemic affected demand for natural gas less than it did demand for oil.

Petroleum products include gasoline and jet fuel, which have been heavily affected by social distancing and stay-at-home orders across the globe.

Gas, on the other hand, is used for industrial power generation and for residential heating and cooling — services that have been impacted by the crisis but not to the same degree, Ozkan said. Demand will go up in the winter when homes need heating, he added.

“Gas looks pretty bright,” Ozkan said. “The stars are aligning for higher prices.”

John Freeman, energy analyst at investment bank Raymond James, also forecasts declining drilling activity and the shut-in wells eventually will boost natural gas prices.

“All things considered, we remain of the view that the market response to the COVID-19 pandemic is setting up the U.S. natural gas prices market for a massive recovery next year,” Freeman wrote in a June 1 report.

U.S. gas prices are currently at $1.83 per mcf. Fine forecasts that price will almost double to $3.25 by the beginning of next year. Freeman sees prices rising to $3.50, while Ozkan believes they could surpass $4.

That’s a far cry from what Merrion is able to get for his gas these days. He said San Juan operators sold their product for only $1.08 per mcf in April, the lowest price he had seen in three decades.

Merrion would know times are exceptionally difficult — his father drilled his company’s first well 60 years ago, and the firm has stayed in family hands, navigating the swings of the energy markets, ever since.

A slow decline

It didn’t use to be that way.

Boasting one of the nation's largest gas fields, northwestern New Mexico was long the state's stronghold for natural gas production.

In the early 2000s, the area was booming as drilling increased and U.S. natural gas prices were high — peaking at above $13 per mcf in 2005. The region's coal mines and power plants were major employers, too.

But then came the Great Recession, and prices fell sharply. Almost at the same time, new technology such as hydraulic fracturing, or fracking, emerged that made it cheaper to drill for oil and natural gas in shale formations such as the Permian Basin and the Marcellus Formation in Appalachia.

The shale boom led to an oversupply of gas, triggering a further decline in prices.

Drilling and production slowed in the San Juan as it became less profitable for companies to operate there and major energy companies like BP and ConocoPhillips left the area, pursuing more oil production in the Permian instead.

As producers flocked to the Permian, oil production there skyrocketed and gas output spiked with it, dwarfing the output in the San Juan region.

"Over the history of New Mexico natural gas, the San Juan Basin was the majority producer. The smaller producer was the Permian," Fine said. "That shifted in 2018 and '19."

The local economy in northwestern New Mexico has been further burdened by plans for the coal-fired San Juan Generating Station near Farmington to close in 2022 as the state transitions toward carbon emission-free energy sources.

And to make matters even worse for the region's economics, the COVID-19 outbreak has taken a devastating toll on the local population, as McKinley and San Juan counties by far have the greatest number of cases in the state. The pandemic also has kept natural gas prices low, and the producers left in the region have halted even more operations.

“We’re not making much money on the oil and gas we’re selling,” said Merrion, whose company operates around 120 mostly gas wells, 40 percent of which are currently shut in.

There are currently 687 natural gas wells and 197 oil wells shut in there, according to the state’s energy department.

Looking ahead to the winter

A potential turnaround for natural gas wouldn’t be immediate.

The gas market is still oversupplied at the moment, as the pandemic has shrunk global demand, and prices likely won’t rise in a meaningful way until the winter, when demand for heating homes increases, Fine said.

New Mexico’s Oil Conservation Division, which regulates oil and gas production in the state, said it sees no signs of increased natural gas activity at the moment, and added there are currently zero active drilling rigs operating in the northwestern part of the state.

“We have not had any increase in permit applications,” director Adrienne Sandoval said.

Additionally, none of the shut-in wells in San Juan — or in the Permian, for that matter — had reopened as of late May, Sandoval said.

There’s another caveat: When prices do potentially rise, they could benefit other gas-producing parts of the country more than the San Juan. Gas from the Marcellus Shale in the Northeast, for instance, is more economical to produce and easier to transport to the East Coast for export, said Alexandre Ramos-Peon, a shale analyst at Rystad Energy.

“Because the industry [in the San Juan] has been beaten down for years now, there are better positions where one would drill for gas,” Ramos-Peon said.

Still, analysts and local producers like Merrion are confident there are better times ahead.

Merrion said he’s even looking to acquire cheaply priced oil and gas assets, hoping to start producing in those areas as prices rise.

Most important is to be able to operate all the wells he already has, he said.

“I’m hopeful we’re going to be able to bring these shut-in wells online,” he said.