



Written by [Bob Adelman](#) on July 20, 2017

## Fracking's Vicious Cycle Making Bondholders Nervous

Investors in high-yield bonds issued by small fracking companies are getting nervous. Last year those bonds, [according to Bloomberg](#), gained some 38 percent as they rebounded from lows set earlier. In June they slipped two percent. In the bond business, that's enough to make bond fund managers and individual investors nervous. It's bad enough that the S&P 500 Energy Sector Index of energy stocks has lost 16 percent so far this year. What's worse is the vicious cycle that frackers find themselves in.



For instance, Continental Resources paid \$77 million to service its debt in 2011. Last year, its debt service was \$321 million. Pioneer Resources' debt service in 2011 was \$31 million. Last year it was \$207 million. Whiting Petroleum paid \$46 million in debt service in 2011 and a breathtaking \$558 million last year.

All told, adding the debt owed by oil and gas producers and their service providers, \$110 billion in debt will have to be paid off, or renewed, by 2021.

The vicious cycle works this way: Energy producers have to produce enough energy to cover their variable expenses and interest costs. They hope to generate more than that, of course, to pay down their debts significantly. The problem is that, as they produce, they flood the world with cheaper and cheaper oil and gas, which means that they must produce even more to service their debts. But as the debts grow — for leases, land purchases, and wellhead development — so do interest costs. So they produce even more, lowering prices further. The end point of this unhappy scenario is that the companies (especially the smaller ones, with weaker balance sheets and smaller reserves) can't even generate enough to cover their variable costs and interest. It's no wonder that bondholders are getting nervous.

The cycle spins more rapidly when bankers start reviewing the value of the reserves these companies are using as collateral for their loans. When loans are up for renewal, banks often will ask for more collateral, or higher interest, or, even worse, they might call the loans.

This scenario is well known to the OPEC cartel. In fact, this has been their strategy ever since Saudi Arabia announced that it would start flooding the market with oil a couple of years ago. Its recent change in policy — limiting production — is under attack. Not only is the price of oil not rising (its target is \$60 a barrel, minimum) as hoped, but compliance with the latest extension of the production cut agreement is now becoming an issue. Members are seeking their own best interests and are producing more than they agreed to.

Knowing what they know, it's reasonable — even expected — that when the agreement comes to an end early next year, the cartel won't renew it. The increase in production could then spell the death knell for those small frackers who have been running up the down staircase just to stay in business.



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The irony in all of this is not that OPEC would have accomplished its objective of removing those pesky small American frackers who have stood in the way of higher oil prices with their unexpectedly large and increasing output. It's that OPEC would have been helped along by American bondholders and banks that see the vicious cycle emasculating their collateral and putting their bonds and loans at serious, if not existential, risk.

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