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Private Equity-Backed Oil Producers Find Coronavirus Relief by Hedging Prices

Energy-focused firms' financial hedges could protect against a coronavirus-prolonged oil price slump

Traders follow markets at the Dubai Stock Exchange in the United Arab Emirates earlier this month.

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By Luis Garcia

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Energy-focused private-equity firms that rely on financial hedges to protect their portfolio companies against a prolonged oil-price slump are running against time.

These firms hope oil prices will recover to profitable levels before their current hedges expire because they could find it harder to lock in higher prices once again.

Private equity-backed energy companies often use a hedging strategy to lock in prices on future output and avoid the risks stemming from a market collapse. Such companies

tend to hedge their production more aggressively than their publicly traded peers because they often are smaller and carry more debt, industry experts said.

“We hedge like crazy,” Wil VanLoh, chief executive of Houston-based Quantum Energy Partners, said about the firm’s many oil sector holdings, which include Middle Fork Energy Partners LLC in the Rocky Mountains, Sentinel Peak Resources in California and ExL Petroleum Management in West Texas.

“You can’t completely take price risk out, but you can significantly minimize the impact of volatile commodity prices by hedging,” Mr. VanLoh added.

Commonly used hedging contracts lock in a price for a certain volume of oil that a company plans to deliver within a specific period, often for as much as three years from the date of the contract. If market prices drop below the agreed or “strike” price of such deals, a bank or other counterparty to the hedge agrees to cover the difference.

But producers often take on risk as well. Hedge agreements call on them to pay the counterparty the difference if the market moves above the strike price, effectively locking in a maximum selling price. Others can drastically reduce their protection if prices plunge below a certain floor. The parties involved seldom take delivery of the crude, but use the contracts as a purely financial tool, according to Thomas Wilson, an associate director at energy consulting firm IHS Markit Ltd.

If oil prices increase above the level set by the hedges, energy companies still could benefit by boosting output, Mr. VanLoh said.

Quantum’s companies took advantage of higher oil prices around the beginning of the year to hedge their full estimated production through next year, with contracts that priced the output at more than $55 a barrel on average, Mr. VanLoh said. The companies further hedged half of their anticipated output for as much as two years more, through 2023.

At the start of this year, West Texas Intermediate crude oil traded at around $63 a barrel. But by Monday, the benchmark price had fallen to close at $20.09 a barrel, its lowest closing price since 2002. The dramatic move reflected both a price war between Saudi Arabia and Russia that erupted earlier this month and a coronavirus-driven collapse in fuel demand that rapidly worsened as the pandemic expanded in the U.S. and Europe.

As private equity-backed producers slow output in response to lower oil prices, hedges that are priced to market and settled monthly can become vital for paying salaries and debt. With such depressed prices, the monthly difference between the hedged price and the market price can generate a flow of cash to the producer with each settlement. It can also provide an opportunity to benefit from a one-time gain by liquidating hedges covering future months.

“We’re able to monetize a little bit of hedges just to give ourselves some extra liquidity,” said Austin Akers, chief executive of Bison Oil & Gas II LLC in Denver, an energy company backed by Houston-based Carnelian Energy Capital. Bison operates in Colorado’s Denver-Julesburg basin.

Around the beginning of the year, Bison secured 18-month hedges through roughly June 2021 for about 125% of its estimated production, locking in prices of $57 a barrel on average. In addition, the company hedged 70% of its estimated production for the following 18-month period through the end of 2022, Mr. Akers said.

In normal times, hedges enable private equity-backed oil producers to assure a certain internal rate of return on the wells they operate.

By hedging, “you’re guaranteed that you can make a strong IRR in a certain price range, why would you take the risk of not being hedged?” Mr. Akers said. “If the market does improve substantially, then that’s great. We can always drill more,” he added.

Oil hedges come in a variety of structures, including some that guarantee producers can sell crude at market prices within a defined price range. This form of hedge agreement is typically more advantageous compared with fixed-price instruments if the market rises, but provides less protection against a slump.

“I think the bigger [question] is, ‘What’s your risk tolerance?’” Mr. Akers said. Range-type hedges are “just slightly more risky, giving you a little bit of upside for pricing if prices go up.”

Mr. Akers added that Bison uses a mix of both kinds of hedges. Quantum favors fixed-price instruments, according to Mr. VanLoh.

“For us it’s all about the certainty,” Mr. VanLoh said. With other types of hedging contracts, “you’re still floating for a significant portion of your revenue.”

No matter how they hedge, energy companies likely will face difficulties with lenders if oil prices don’t recover for an extended period.

“If oil prices remain this low for any reasonable time period,…a lot of people are going to be in violation of their debt covenants,” Mr. Akers said. “I think this will be the true moment of reckoning.”

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