

SEARCH



Out of Gas

WILL THE SHOCKING FALL OF LATE FRACKING BILLIONAIRE AUBREY MCCLENDON TAKE DOWN A CHUNK OF THE HOUSTON ENERGY SECTOR?

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ILLUSTRATION BY JONATHAN BARTLETT

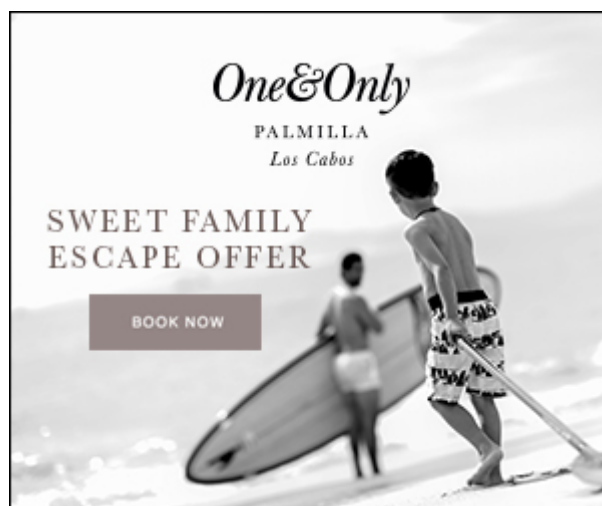
On March 2 John Raymond, the CEO of the Houston private equity firm Energy and Minerals Group (EMG), sent a notice to his investors saying he would no longer do any new business with Aubrey McClendon. An Oklahoma-based fracking pioneer who had built Chesapeake Energy into the country's second-biggest natural gas producer,

McClendon was on the verge of an astonishing fall: the day before Raymond sent out his memo, McClendon had been accused by federal prosecutors of rigging bids for drilling rights, a violation of antitrust laws. EMG, which had poured more than \$3 billion into McClendon's newest company, American Energy Partners, was in danger of getting pulled down with him. "These are serious allegations . . . and EMG takes this matter very seriously," Raymond wrote.

That same morning, McClendon went to his office, sent a few emails, then ditched his security detail and climbed into his 2013 Chevy Tahoe. From American Energy's headquarters, he headed north out of Oklahoma City. Less than twenty minutes later, as he approached an overpass, his car swerved from the right lane, veered across the road, and slammed into a bridge abutment at 78 miles per hour. McClendon, who wasn't wearing a seat belt, died on impact.

Before everything fell apart, McClendon was a rock star of the energy sector, known for his tangle of silver hair and his boundless enthusiasm. In 1989 he co-founded Chesapeake and, over the course of two decades, built it into a company that won a coveted spot on the Standard & Poor's 500. Then, in 2008, after he saw the promise of fracking, the company took off. Between 2008 and 2013, no one drilled more natural gas wells than Chesapeake. "He learned a lot about shale reservoirs and was a real innovator there," says Dallas oilman T. Boone Pickens. "I hope people remember how creative he was."

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Much of McClendon's creativity focused on finance. A single shale well can cost as much as \$8 million to complete, and the production trails off rapidly, so frackers must drill more wells than conventional drillers, which means they're always hungry for capital. And

sometimes that hunger has led men like McClendon to make very bad decisions.

Whenever McClendon needed money, he looked to Texas first. Texas money men made him, Texas executives are cleaning up the messes he left behind, and Texas companies will likely suffer collateral damage for his mistakes. “It’s the Enron story all over again,” says Art Berman, a Sugar Land oil and gas consultant who for years has warned that the high cost of shale drilling is unsustainable. “It’s part of the same symptom, this insatiable need for access to capital to keep going.”

The first person McClendon would turn to when he needed cash was an old fraternity brother from his Duke University days, Ralph Eads, the Houston-based vice chairman of the New York investment firm Jefferies & Company. While McClendon was building Chesapeake, Eads, a fifth-generation Texan, worked his way through a series of big-name Wall Street firms. In 1999 he joined Houston’s El Paso Corporation, setting up a merchant energy division to compete with Enron, using similar off-balance sheet partnership structures. In the wake of Enron’s bankruptcy, in 2001, the federal government launched an investigation into market manipulation by El Paso’s traders, some of whom pleaded guilty. Eads wasn’t accused of wrongdoing, but El Paso shuttered the operation in 2002, after heavy losses. Eads went back to investment banking, joining a Houston boutique firm, Randall & Dewey, which Jefferies bought in 2005.

By then, McClendon was buying large swaths of acreage on the cheap, before most competitors realized what he was doing. With Eads’s help, Chesapeake funded drilling with financing vehicles known as volumetric production payments, which basically sold a percentage of a well’s future production to pay for the cost of drilling it. VPPs were typically used by smaller drillers that couldn’t get bank financing, not companies the size of Chesapeake, which by 2010 had more than \$9 billion in annual revenue. Eads arranged \$28 billion in financing for Chesapeake between 2007 and 2012, and then he and Jefferies collected more fees by refinancing that debt in 2013. “He built a business around funding Chesapeake and then saving Chesapeake,” Berman says. Jefferies, which was not a major generator of oil and gas deals when Eads came on board, transformed itself into one of the country’s top energy deal-makers six years later. (Eads declined to comment for this story.)

In Oklahoma City, McClendon became a local hero. He was part of a group that bought the Seattle SuperSonics, moved the team to Oklahoma City, and renamed it the Thunder, the only major league sports team in the state. He supported the symphony, the University of

Oklahoma, numerous parks, the Boy Scouts, and schools for homeless children. “He co-created an extraordinary company, a company that employed thousands of Oklahomans, a company that provided vision and leadership,” former governor Frank Keating told more than four thousand people at McClendon’s memorial service.

Yet throughout his career, McClendon had his detractors; *Forbes* called him “America’s most reckless billionaire.” It was often difficult to determine where his money ended and Chesapeake’s began, because the company’s board rubber-stamped anything McClendon wanted. Chesapeake allowed him to invest personally in the company’s drilling deals, and he used his stakes in those wells as collateral to borrow more than \$1 billion and then used that money to invest in more wells. McClendon was also one of Chesapeake’s biggest shareholders, and he borrowed against his stock holdings as well. The *Oklahoma Gazette* wryly noted that “you can’t spell ‘McClendon’ without ‘lend.’”

“Aubrey always believed that prices would save him,” Berman says. But as time went on, it became increasingly clear they wouldn’t. By 2012, things began to unravel in epic fashion as natural gas prices fell below \$2 per thousand cubic feet, from a high of \$13, in 2008. Yet the demand for shale wells was driving up the price of leases; Chesapeake was paying more for land even as it was getting less for its production.

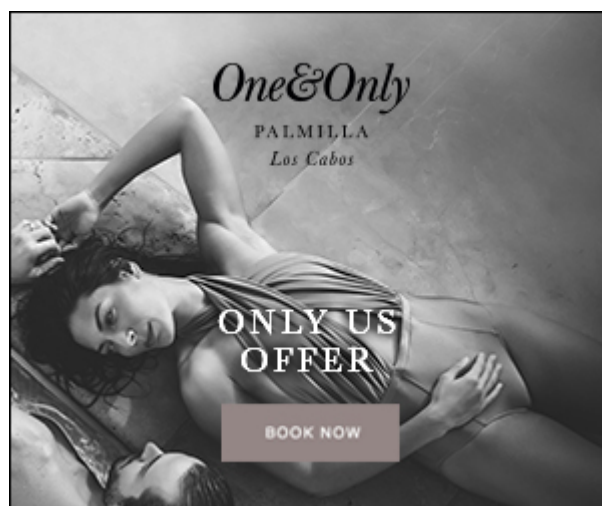
As Chesapeake’s shares fell, activist investors bought them on the cheap, taking control of the board in the summer of 2012. They stripped McClendon of his chairman’s title and, to keep him in check, hired Archie Dunham, the former CEO of Houston-based ConocoPhillips. Dunham initiated a program to sell billions in assets and clean up Chesapeake’s reputation; by then it faced a Securities and Exchange Commission investigation and seventeen shareholder lawsuits. McClendon’s days as CEO were numbered, and in January 2013 he announced he would leave. The board replaced him with Robert Lawler, a senior vice president at the Houston-area firm Anadarko Petroleum.

Just weeks after his ouster, McClendon launched his new company, American Energy, up the street from Chesapeake’s campus. But he struggled to bankroll his new business, because the terms he wanted were so favorable to him that most potential investors turned him down. His college buddy Eads was still working with Chesapeake, so he suggested McClendon talk to John Raymond, the Energy and Minerals Group CEO and the son of Lee Raymond, who built Exxon into the world’s most valuable company. Raymond had followed in his father’s footsteps, rising through the oil industry’s ranks at a fast pace; the Houston

oil and gas producer Plains Resources hired him as its chief executive when he was just 32. A decade ago, he set up EMG, which now manages \$16.5 billion.

In 2013 Raymond met McClendon for dinner. No doubt concerned about McClendon's history of recklessness, Raymond persuaded him to give EMG final say on all key business decisions. It got first rights to every deal McClendon put together, while McClendon would focus on what he did best: finding drilling prospects. He may have made a mess of Chesapeake, but he put the company into some of the country's hottest natural gas plays early. "There's no one in the business that's better than Aubrey," Raymond told the *Wall Street Journal* in 2014. By maintaining control over the finances, Raymond believed he could keep McClendon's risk-taking in check.

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EMG's involvement attracted other investors, and a little over a year after he founded American Energy, McClendon had raised \$14 billion and hired six hundred people. It certainly didn't hurt that during that time the price of natural gas crept up again, to more than \$6—before beginning a slide that would take it back under \$2 this year. Just as with Chesapeake, the combination of rapid growth, heavy debt, and plummeting prices eventually caught up with McClendon. In late February Raymond began cutting his ties to McClendon. (Raymond declined an interview request for this story.)

At 5:30 p.m. on March 1, a federal grand jury in Oklahoma City brought its indictment against McClendon, claiming he had "orchestrated a conspiracy between two large oil and gas companies" between 2007 and 2012. "The conspirators would decide ahead of time who would win the leases," the U.S. Department of Justice said. The winning bidder would then allocate an interest in the leases to the loser. McClendon's response, issued within hours,

was characteristically defiant. “I have been singled out as the only person in the oil and gas industry in over 110 years since the Sherman Act became law to have been accused of this crime in relation to joint bidding on leaseholds. I will fight to prove my innocence and to clear my name.” The next morning, he died at the wheel of his car.

Months after his death, many are still dealing with the fallout of McClendon’s legacy. In recent years, investors large and small have flocked to the energy sector; the potential for loss may be concentrated among private equity firms, but numerous public pension funds are invested in those firms. And one of Chesapeake’s biggest shareholders is Vanguard, which provides mutual funds for millions of retirees. The full repercussions of McClendon’s collapse may not be known for years.

Many of those repercussions are being felt in Texas. In Houston, Raymond is trying to unwind the partnership deals with McClendon, but weak prices have left EMG in a bad position; S&P estimated in March that the firm could lose as much as \$2.6 billion on a half dozen of the deals it did with McClendon. Unless oil and gas prices rebound, it could join the more than 135 oil and gas companies that have filed for bankruptcy since the start of 2015. Meanwhile, Archie Dunham, who is now Chesapeake’s chairman emeritus, and Robert Lawler, who left Houston for Oklahoma to clean up Chesapeake, are having a tough go of it. Chesapeake has cut almost two thirds of its workforce since 2011, and in February rumors circulated that the company was near bankruptcy. Only Jefferies has remained relatively unscathed. It made its money from the fees it collected by putting together Chesapeake’s financing and refinancing deals; it doesn’t really matter to the firm how those deals work out. But, of course, the energy bust that inevitably followed the McClendon-driven boom has left Jefferies with few energy deals to make.

Aubrey McClendon may be gone, but in Texas and Oklahoma, the tab he ran up is just coming due.

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