Oil Prices Will Go Down But U.S. Shale Will Survive

WASHINGTON – After the oil production cuts recently announced first by OPEC and then non OPEC oil producers, oil prices rallied. This is because supply cuts must mean tighter markets and therefore higher prices. Well, looking at what most energy sector analysts say, this idea of a sustained oil rally is a dream that will soon end. And this is because there are too many exemptions to these announced cuts, too many special cases and too many opportunities to cheat, since rather modest total production cuts are to be spread thinly among many producers.

Oil prices will fall again

Who is going to check about full compliance? Bottom line, expect oil prices to lose altitude again, as soon as hard data about production among OPEC and non OPEC countries will become known, probably towards the end of January. Keeping all this into account, while West Texas Intermediate, WTI, closed at about $ 53 on January 5, it is hard to believe that it will stay at that relatively high level for much longer.

What will happen to the U.S. shale sector?

That said, the really interesting question, assuming persistent low crude prices, is whether the U.S. shale oil industry will be able to withstand another prolonged price squeeze.

If recent history is good guidance, I would say: yes, it will. Surprising everybody, the American oil shale sector, until a few years ago deemed to be profitable only assuming oil would stay at or above $ 60 per barrel, managed to survive, when oil beginning in 2014 went down to $50, $ 40, and even $ 30 per barrel.

Of course, the success record is quite uneven within a sector characterized by so many diverse players that differ in terms of size, profitability of their reserves and financial conditions. Many shale energy company, especially those carrying quite a bit of debt, just could not make it. They went bankrupt. Others were bought by stronger competitors.

U.S. shale oil sector made up of diverse players

In truth, there is no such thing as a homogeneous U.S. shale oil sector. There are many energy companies operating in different states. Each one is different. And the chances to survive or thrive in a tough market environment because of low oil prices depend on many factors unevenly spread. Indeed, while examining companies, analysts have to take into account the specific geology that will affect production techniques and oil recovery levels and related costs, the company’s management skills, the amount of debt each company carries, the ability to apply in a timely manner state of the art new technologies, and a lot more.

Still, even taking to account that some companies are strong and some very weak, with many more in between, it is fair to say that the sector as a whole proved to be surprisingly resilient, given the low profit margins in a depressed oil price market.

Sustained production

Yes, the total U.S. rig count went down, dramatically, following the 2014 price collapse. But overall production, with some ups and downs, did not go down that much. The shale oil sector proved to be quite flexible.

While large conventional operations cannot be brought on line, closed and restarted at will, the shale sector is far more flexible. And this means that shale operators do not need to bet on a 5 year window of high prices that will guarantee profits in order to start operations.

They can quickly respond to price fluctuations, producing more when prices are high; while shutting down production when prices drop below their break even point. Look, obviously it is not just like flipping a light switch. But you get the idea. Shale is nimble.

How much flexibility and resilience?

So, flexibility and resilience define the American shale oil sector. But here is the question. Is it possible for U.S. shale to become ever more productive and nimble? Or, at some point, no matter how much they try to cut costs, the energy companies hit a profitability wall?

While we know that the shale plays in the Permian basin in Texas can stay in business even with oil at $ 40 or even $ 30 per barrel, what about all the other reserves in Oklahoma, North Dakota and other states? If we assume prices going down to $ 40 or even $ 30 per barrel for an extended period of time, how many shale companies, many of them operating in far less favorable locations, have a realistic chance to survive, let alone be profitable? Can new fracking technologies perform more miracles, or has the sector become as productive as it can get?

How long can Saudi Arabia endure the adverse impact of lower oil revenue?

The honest answer is that we do not know. That said, we also do not know how long oil prices will stay this low. Indeed, we do not know how long Saudi Arabia, the world's biggest producer and OPEC's *de facto* leader, can endure the economic and fiscal impact of low prices without resorting to much steeper cuts in order to jack up prices and therefore state revenues.

We all know that Saudi Arabia's oil industry will be profitable even with oil at $ 30 per barrel, because Saudi extraction costs are very low. But the problem is that the

Saudi Government depends on high oil prices to finance practically everything.

While the Monarchy is trying to change things, right now the Saudi State needs to lubricate with cash infusions a rent based society in which hardly any Saudi citizen is engaged in truly productive activities.

Low oil prices hurt

Which is to say that low oil prices hurt different producers in different ways. OPEC now has tried to drive prices up by announcing relatively modest production cuts to be spread among various producers. Some non OPEC countries indicated that they would also participate, with the shared objective of jacking up prices.

Based on what know, this time the trick probably will not work, because too many producers are saying one thing about cuts and then planning to do the opposite (keep production levels high, or in some cases, ramp up production).

When will Saudi Arabia announce serious cuts?

But at some point Saudi Arabia will start running out of cash; and so it will have to cut its oil production in order to drive prices up. This would help the Saudi state immensely in its effort to stabilize its finances. However, any Saudi move aimed at supporting oil prices would also help the marginal U.S. shale producers. Some of them are hanging tight, hoping for better days to come.

In other words, who will give up first? Will the U.S. shale sector be eventually defeated by prolonged low oil prices? Or will Saudi Arabia have to swallow the bitter pill and cut production (therefore giving up some of its market share) in a far more significant way in order to drive prices up, with full knowledge that this will help U.S. shale companies?

Bet on Yankee ingenuity

All in all, when it comes to endurance and resilience in adverse market conditions, I would still bet on Yankee ingenuity. The American shale oil industry surprised the world by inventing and then deploying hydraulic fracturing (fracking) and horizontal drilling on a large scale, this way bringing on line millions of barrels of oil that was deemed to be unrecoverable. And then they delivered an even bigger surprise when they managed to make the entire sector much more productive and efficient in record time, when faced with a sudden crude oil price collapse.

None of this could be done, everybody said. And the shale oil people did it. May be they will keep doing it, surprising all analysts once again.