OPEC Defeated By US Shale Oil?

WASHINGTON – It seems that American shale oil producers, an assorted group of small and medium-sized firms which gained strength in the last decade and are now operating in many states, have become the swing producers in a position to influence global oil prices. How did that happen?

Cutting costs

U.S. shale oil production is relatively new. At the beginning of the "shale revolution" the cost of extracting oil from shale formations was quite high. But now they have come down significantly, mostly because of aggressive cost cutting measures adopted in response to OPEC imposed low prices. (More on this below). On account of this incredibly fast makeover, today a large number of the shale companies, especially those operating in West Texas, are profitable even with oil well below $ 50 per barrel.

Most interestingly, shale oil producers now have the ability to ramp production up and down with relative ease, this way adjusting to global market conditions, without causing major disruptions to their operations. They can increase output when prices are higher and cut back when prices are too low. Conventional oil producers do not have this option.

With crude around $ 50 per barrel, it is good news to have a substantial number of U.S. based oil producers supplying the domestic market, while making a profit even in this new era of low prices. This is a big plus for the American energy sector, and for all American consumers of energy products.

OPEC reactions

With good cause, OPEC saw the spectacular increase of U.S.

production caused by the large scale exploitation of abundant shale oil reserves (an additional 4 million barrels a day in just a few years) as a threat to its market dominance.

Hence a very simple strategy aimed at eliminating the American shale oil threat. The plan was to deliberately over produce, this way causing a global glut and consequently falling oil prices. The bet was that a long stretch of low prices would kill the U.S. high cost shale newcomers who –according to all analysts– could not survive with oil below $ 60 per barrel.

After having eliminated the U.S. menace, OPEC would go back to business as usual, reaffirming its position as the oil cartel which alone has the power to dictate prices by manipulating supply.

The strategy failed

But it did not work out this way. Not by a long shot. And this is because the U.S. shale producers, surprising everybody, managed to quickly adopt major technological improvements which increased well productivity, while aggressively cutting other production costs, this way staying profitable even with oil below $ 50 per barrel.

All in all, the Saudi/OPEC plan failed. While several marginal U.S. shale producers could not make the adjustments fast enough and went bankrupt, most of the shale sector survived the OPEC imposed squeeze on profits.

The high cost of low prices

In the meantime, the extended period of low prices hurt OPEC producers very badly. They saw their precious oil based revenue dwindle rather dramatically. It soon became clear that most OPEC countries could not sustain an extended period of low prices.

Therefore, led by Saudi Arabia, the OPEC cartel, (this time working in concert with non OPEC Russia), tried to change strategy and jack up prices by cutting production, this way eliminating the oil glut they had created.

But this new approach is also failing. As oil prices go up on account of OPEC/Russia production cuts, the U.S. shale companies ramped up production, this way offsetting the OPEC/Russia cuts. As OPEC imposes cuts on its members, the U.S. shale sector produces more, while Saudi Arabia is denied the revenue gains that should have resulted from production cuts. So, the OPEC strategy aimed at eliminating the U.S. shale threat to its market dominance did not work.

Loss of precious revenue

That said, the sustained “attack” against US shale has been horribly expensive for the OPEC cartel members. Years of low prices hurt major Middle Eastern oil producers, (not to mention Nigeria and Venezuela, and non OPEC Russia, among others), in a significant way.

Most of these countries rely heavily on oil revenues to finance all or most public spending. Many of them had adopted national spending programs and budgets which assumed oil prices at $ 90, or $ 80 per barrel.

This means that all of them are facing fiscal problems or outright crises. Lacking oil revenue in the expected amounts, they have to cut spending and borrow more in international financial markets. But this is not an easy adjustment.

For example, in Saudi Arabia major spending cuts caused by declining oil revenue could lead to unprecedented political problems down the line. Almost the entire Saudi population depends one way or the other on direct or indirect government subsidies funded entirely via the oil revenue.

Reforms will take time

We know that the Saudi Monarchy is now openly committed to a major economic and fiscal transformation which will (hopefully) reduce and eventually eliminate all state subsidies, while promoting plans aimed at diversifying the economy. But, even in the best of circumstances, this is going to be a long journey. Cutting government largesse too much too soon could be politically dangerous.

Bottom line; U.S. shale wins; OPEC cartel and its new allies lose.