THE AUSTRALIAN FINANCIAL REVIEW

Oil price plunge tests US shale revolution

John Kehoe

November 27, 2015

When the price of an American barrel of crude oil collapsed beneath $US40 ($55) this week, drivers filling up their petrol-guzzling SUVs may have celebrated but it was a cruel blow to struggling energy producers.

Across the United States, oil companies are cancelling projects, laying off workers and cutting costs to cope with the oil price almost halving over the past year.
Yet paradoxically, US oil production, which hit a 43-year high of 9.4 million barrels a day in May, has barely edged lower from its record level.

"The US shale oil industry has proven to be a lot more resilient than people expected it to be," says Uday Turaga, chief executive of Texas-based consultancy ADI Analytics.

A few small oil companies are bankrupt and thousands of rough necks have lost their jobs. But most experienced drillers have weathered the price plunge, at least until now.

Continually improving technology, trimming prices paid to oil field contractors, and drilling faster and deeper, have cut costs by 15 to 30 per cent and made output more efficient.

STERN TEST

But the latest leg down in prices means the great American shale oil revolution, enabled by deep fracking and advanced new horizontal drilling technology thousands of metres beneath the surface, is facing its sternest test.

Major energy companies, including BHP Billiton operating at the Eagle Ford shale plate in southern Texas, struggle to earn a profit at these prices. Average break-even costs are about $US40-60 a barrell across the Eagle Ford, Permian basin at west Texas and the North Dakota bakken.
Skip York, an integrated energy analyst at consultancy Wood Mackenzie, said US oil production had "turned" and he expected it to decline until early 2017. Most analysts say US output won't plunge.

Unless Saudi Arabia commits a serious u-turn and meets the demands of Venezuela and Nigeria to cut production at the OPEC meeting on December 4, global oil prices are likely to remain depressed.

Short bets against the price of oil by money managers this week reached a yearly high, Citigroup says.

The world is flooded with oil, with little sign of respite. Iran is likely to bring 500,000 to 700,000 barrels a day on stream when sanctions are soon lifted.

CHINA INFLUENCE

But Barclays head of energy commodities research in New York, Michael Cohen, says the fundamentals of supply and demand are not what's driven the latest dive in prices this month.

"The price level right now is being driven by perceptions about what's going on in China and the Fed raising rates strengthening the dollar," Cohen says.

Energy traders are worried about China's cooling economic growth and the potential negative effect on energy demand. The US dollar is also surging on bets the US Federal Reserve will begin lifting interest rates next month.

"Oil is priced and invoiced in [US] dollars, so it means the price of oil in all these domestic currencies around the world goes up and that tends to dampen the demand for oil," says professor Steve Hanke of the Cato Institute.

To clear the market, when the US dollar rises, the price of oil usually falls.

Mr Cohen warns many oil firms are still "living off their hedges" against a falling oil price. The oil revenues of producers are typically hedged 20-30 per cent this year, but that protection will start to roll off next year leaving them exposed if prices don't bounce.

PRICE RECOVERY

Barclays is tipping a gradual price recovery for US West Texas Intermediate into the mid-$US60s in the second half of 2016.

Wood Mackenzie sees the Brent oil price, the international benchmark, rising to the low $US70s later next year. That level is well below the $US100 a barrel some high-cost, oil producing countries require to stay afloat.

In the US, small cracks are emerging in the financial viability of onshore tight oil drilling. About 300,000 barrels a day have come off in the past six months and the North Dakota bakken formation posted its first annual output decline since 2011.

The mini-downturn has been masked by total US production remaining above 9 million barrels a day, thanks to offshore rigs in the Gulf of Mexico and Alaska coming back online after maintenance shutdowns.

Mr Turaga expects large players to take advantage of the tough conditions and acquire assets on the cheap, but is not expecting American producers to slash production.

"If it stays around $US40-50 I think we will see moderate declines in US oil production," he says.

More broadly, geopolitics in a volatile Middle East is the big wildcard. Oil temporarily lifted this month after France bombed Islamic State oil trucks in retaliation for the mass terrorist attacks in Paris, and Turkey shot down a Russian jet near around the Turkey-Syria border.

When the oil price plunged to about $US10 in 1986, the US oil industry was in dire trouble so US politicians influenced Saudi Arabia to cut the supply level and raise the price.

But this time US politicians are sitting pat – not wanting to raise politically sensitive petrol prices for drivers. Saudi Arabia is pumping feverishly. Theories abound that the Saudis want to steal market share from US producers to eliminate the global threat of shale. Geopolitically, the Saudis may also be trying to punish its enemy, Iran, as it re-enters the market.

Barring a major breakout of war or a change of tune by the Saudis, drivers should continue to enjoy low prices at the pump and oil producers will be battling.