Insight beyond information

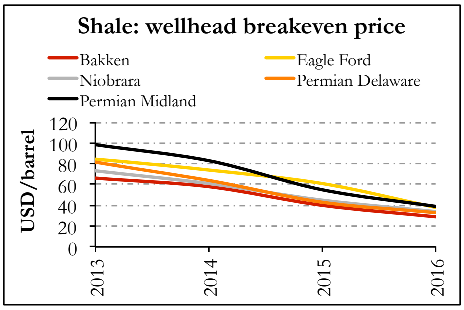
EXECUTIVE BRIEFINGS
BUSINESS AND ECONOMY: OIL PRICES

Adit Jain, IMA India
September 2017

Cheap oil: here to stay?

Hydraulic fracturing, also known as fracking, to extract hydrocarbon reserves trapped in shale rock formations created a riot in the energy industry a few years ago. Within a short span of time, shale oil companies were producing massive quantities of oil and gas. They were largely responsible for causing crude prices to collapse from a peak of USD 125 a barrel in 2011 to almost a fifth by 2015. However, whilst the world rejoiced, the industry itself came under pressure. Shale businesses were mostly privately held maverick corporations not coordinated under cartel arrangements. Their unsynchronised efforts to indiscriminately add to global oil supplies meant that prices fell faster than anticipated. Conventional oil producers – the Organisation of Petroleum Exporting Countries (OPEC) – were biding their time, perhaps fuelling the price decline to drive shale companies out of business. Sure enough, by the end of 2016 the top 30 shale producers were USD 130 billion in the red and another 120 companies went bankrupt. It seemed to be the beginning of the end of the cheap oil dream.

However, events that followed proved two things. First, the resilience of fracking technology and second, the power of free market capitalism, even in an industry historically captive to cartels, were no pushovers. On the one hand, significant enhancements were made to drilling processes resulting in progressively lower break-even prices (BEP). Amongst the five major shale producers in the US, average BEP came down from USD 66-98 a barrel in 2013 to a remarkable USD 29-39 by 2016 (see chart).



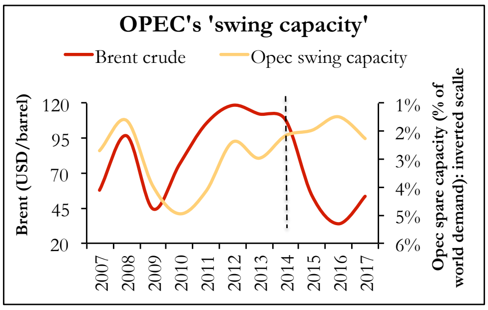
Source: Rystad Energy NASWellcube

At the same time, with the high-risk phase behind it and fracking now a proven technology, the industry was ripe for consolidation. Sensing a longer term opportunity, 'big oil' entered the shale business with a wave of buyouts, backed by large war chests for the next round of investment. Chevron and Exxon alone plan to spend USD 40 billion over the next ten years in shale acreages in America. The US Energy Information Administration (EIA) believes that America's shale production can double from the current 14.1 trillion cubic feet (tcf) to 27.5 tcf by 2050. Globally, shale and other tight gas production is projected to increase from the current 24 tcf to 82 tcf by 2050. In percentage terms, it would double its share in total gas production from 19% to 39%. This suggests an annual increase of 3.6% for shale against 0.7% for conventional gas, a serious rate of growth given the time frames involved.

Whilst the economic consequences of these developments are obvious, there are strategic implications as well. The decline in the oil price and the fact that shale supplies will come largely from non-OPEC countries such as the US, China, Argentina and Canada implies a fundamental change in OPEC's grip over the oil industry in the coming years. Historically, OPEC members through their cartelised actions have influenced oil prices by adjusting production whenever prices have threatened to fall too low. This power is weakening and is likely to wane further in the years ahead.

Insight beyond information

One measure of this is OPEC's 'swing capacity', the relation between crude oil prices and its spare production capacity. As the chart shows, from 2007 to 2013, OPEC's spare capacity moved in tandem with oil prices, implying a high degree of control. However, since 2014 the two parameters have decoupled and are practically moving in opposite directions.



Source: US EIA, India Economic Survey 2016-17, IMA analysis

For energy importers such as India these developments constitute good news. Firstly, they imply that oil prices will huddle at levels of USD 50 in the medium term and perhaps even lower in the longer term as shale breakeven prices fall further. This will help keep their currencies stable and inflation low. Secondly, they can look forward to a world where they are no longer hostage to the interests of oil cartels, creating opportunities for reshaping geopolitical dynamics and foreign policy. The dream of cheap oil goes well beyond hydrocarbon economics and it is by no means over.