Oil Prices and the Economics of Extraction

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The precipitous drop in oil prices reflects how the economics of extraction are now the primary concern for energy sector investors, rather than the geological or geopolitical limitations that used to be part of the calculus. Development of abundant US resources has boosted supply growth faster than trend-line global demand growth, an impressive performance by a single country within any geographical, geological or historical context. The market is still digesting the extent of crude oversupply and adjusting the trajectory of expected growth.

At $60 to 70 per barrel, the price of oil becomes lower than the cost of new investment. Given this, low crude prices will ultimately prompt a supply response, but it could take 12 to18 months. Right now, there is still far too much momentum in US unconventional liquids growth, aside from the inventory where capital has been sunk and production is imminent. Hedge books, continued cost efficiencies, lower transportation costs/ bottlenecks and scalable infrastructure are just some of the reasons why production growth is likely to remain in the 1.0-1.2 million barrels-per-day (bpd) range. Our most aggressive demand forecast is about 1 million bpd globally for 2015.

A supply correction is in the cards, but it is still many months away.

Because reduced investment will take a long time to impact supply, the only way to balance supply quickly is through shut-ins, when oil wells are essentially turned off. Shut-ins take place when oil prices fall below the cost of operating a well, estimated at about $30-40 per barrel on the high end. Shut-ins, much like OPEC cuts, generally impact supply within three months.

In the near term, we see downside risk to oil prices into the $50s or lower. In looking for a bottom, we are keeping an eye on the forward futures curve, which has moved into contango over the past several weeks. Contango occurs when prices in the future are expected to be higher than those today. Liquidity in out months is largely supplied by producers hedging an investment. If that liquidity dries up, it means that producers are no longer willing to invest fresh capital and lock in that future price for when the asset comes online (assuming a 12-month average cycle), demonstrating the impairment of investment economics. We think a supply correction is in the cards, but it is still many months away.

We have great confidence that investment economics will ultimately balance markets.

The only way we see the oil market getting balanced to an $80-90 range would be through:

– A surprise cut from OPEC (more than 1 million bpd)

– US production curtailment

– Continued recovery of global demand, which is on pace and may actually accelerate with lower oil prices (though it will still take 9 to 12 months to absorb supply)

Within OPEC, Saudi Arabia is the only producer that has ever really cut production, but it is unlikely to shoulder this burden alone again, especially given the challenges posed by its own fiscal budget and the realization that the US may overwhelm OPEC policy decisions. Saudi Arabia would only cut if everyone else in the cartel would share the pain. A cut of more than 1 million bpd would be needed to impact the market, and that represents 10% of Saudi Arabia's production and oil revenues. Venezuela had sought a 2.0 million-2.5 million bpd cut, far more than OPEC could stomach, but probably an indication of concerns about US supply momentum and OPEC's irrelevance to supply growth.

Another factor affecting the future of oil prices is the Dodd-Frank Act. During the last period of contango, investment banks purchased oil to sell at higher prices in the future, booking a profit as long as the spread exceeded storage costs. However, the Volcker Rule has led most banks to exit speculative commodity behavior with their balance sheets.

We have great confidence that investment economics will ultimately balance markets. A wild-card event could challenge production economics, but we believe the US energy revolution, even in the absence of demand growth, will take global market share and thus provide an oil-volume investment story, if no longer an oil-price story.

As part of our focus on oil volume over oil prices, we look for bottlenecks in the energy supply chain, which remain transportation and infrastructure. We view investments in pipes, barges and railways as still attractive. More tactically, with near-term oil-price uncertainty, we are looking at hedging with stocks of companies that consume oil, as the pullback has been significant enough to benefit costs and economies continue to grow.

If we suspect stabilization in oil prices, we think investors should consider looking into increasing positions in service companies. They too are volume beneficiaries and represent a better balance between risk and reward than direct commodity producers, as we view prices to be structurally lower in a non-OPEC, short-investment-cycle, US-shale-driven world.

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