1 Oil & Gas CEO Has a Harsh Warning for the Rest of the Industry

Description

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Any investor with a financial stake in the oil & gas market is doing themselves a disservice if they don't listen to **Schlumberger's** (NYSE:SLB) management call every quarter. As the world's largest oil services company — with clients ranging from micro-cap producers to Saudi Aramco — it can take the pulse of the industry better than any other company out there.

This past quarter, CEO Paal Kibsgaard's comments on the direction of the oil market were like an Aaron Sorkin inspired soliloquy. Not only did he lay out a slightly worrisome trend that no one seems to be paying attention to, but he also took Wall Street to task for its support of what he sees is the irrational support of the U.S. shale industry.

If you get a chance, go read the whole thing. If you are pressed for time, though, here are some of the firebombs Kibsgaard threw at the industry and what it could mean for the future of the oil markets.

Is U.S. shale production irrational?

U.S. oil & gas production has been nothing short of a miracle over the past decade and a half. Think back to 2005-2007. Oil production had slipped to 5 million barrels per day, we were importing more than two-thirds of our total demand, prices were at $100 a barrel and climbing every day, and gas production was on the decline such that we thought we would need LNG terminals to import the stuff.

By developing the technology to make shale a commercially viable production source — thanks, horizontal drilling — we now have an oil reservoir competing for the largest in the world, a natural gas supply that could last a century, and we can produce it at a reasonably cheap price.

As great as this all sounds, Kibsgaard wants to throw a little cold water on U.S. shale. He believes that the rapid decline in breakeven prices for shale has led to a wave of irrational exuberance from equity investors that has led to unsustainable growth.

> The production level from the U.S. land E&P companies which currently represent around 8% of global oil supply is largely driven by the U.S. equity investors who are encouraging, enabling and rewarding short term production growth in spite of marginal project economics.
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> The fast barrels from U.S. land are facilitated by a factory approach to both drilling and production and supported by a rapidly scalable supplier industry with a low barrier to entry. In this market the pursuit of equity appreciation outweighs the lack of free cash flow, net income and return on capital employed for both E&P companies and the service industry.
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> And although the fast barrels from U.S. land have already cooled the oil price sentiments as well as the evaluation of the equity investments themselves, this has yet to limit the investment appetite for additional production growth.

Kibsgaard has a point here. It wasn't that long ago — 2014 to be precise — when independent U.S. oil & gas producers were taking on mountains of debt to fuel double digit production growth each quarter. The common phrase we heard was "we'll grow into our debt load." That ultimately proved disastrous as the price of oil fell from $110 a barrel to just $26 a barrel in January of 2016. We all know how that went over.

Since then, producers have become much better at drilling for shale, and many can generate operating cash returns at $50 a barrel. That doesn't change the fact that many are still spending more to grow than what is coming in the door in any given quarter. As it stands, it's an unsustainable and irrational trend to follow. Then again, Allan Greenspan coined the term irrational exuberance in 1996, and it took another four years for the dot-com bubble to pop. So there is no telling how long this irrational behavior can continue.

The biggest losers of the "shale vs. OPEC war"

Nothing sells newspapers or gets clicks more than pitting the U.S. against OPEC. Between the oil crises of the 1970s, the Persian Gulf War, or peak oil back in the 2000s; OPEC and its dominance of the global oil market is an easy target for vitriol. So when America's oil production started taking off thanks to shale, every journalist and their cousin lined up to write a piece on how shale production would impact OPEC and other American rivals such as Russia. Everything was a piece on draining Saudi Arabia's cash reserves or potential instability in the Middle East and how U.S. shale was causing it all.

What all of that jingoistic journalism overlooked, though, was more than half of the global oil supply. These sources are the ones have *really* suffered since oil prices started to crash. Unlike shale producers, the market held these companies to standards related to free cash flow and returns on invested capital. As a result, Kibbsgaard said these companies have drastically cut back on their exploration and development spending.

> The last book of producers making up the rest of the world today represents over 50% of global oil production and covers a broad and diverse group of IOCs [integrated oil

> companies], NOCs [national oil companies], and independent operators. In aggregate, this group is for the third successive year highly focussed on meeting the cash return expectations of their shareholders whether these are equity investors or governance.
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> The operators meet these requirements by striving to keep production flat by producing their existing outlets past their normal and by limiting investments to what provides short term contributions to production at the expense of increasing deplection rates.
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> These producers have also benefited from a production tailwind of 500,000 barrels to 700,000 barrels per day in each of the past three years coming from new projects where the majority of the investments were made in previous years.

We haven't noticed the impact on these oil producers because their production rates haven't declined much, their longer-term investment projects have become operational, and U.S. shale has stepped in to pick up some of the slack in the market. What we don't see in those numbers is depletion rates. These are the rates at which a producer depletes any given reservoir. Many companies have looked to maintain production and juice returns by getting more out of existing sources. In doing so, they have shortened the window those reservoirs will produce, and future production will decline at a much faster rate.

What does this mean for the big picture?

I'll just leave it to Kibsgaard to lay it out.

> [W]ith a low rate of new projects being sanctioned since 2014 this tailwind will taper off in the coming years. This harvesting approach is not uncommon for conventional oilfields that are in their last years of life prior to being shut in. However, this investment in stewardship model is unsustainable for a vast resource space that is both expected and required to provide a substantial part of global oil production for decades to come.
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> Needless to say, the longer the current under investment carries on, the more severe the cliff like decline trend will likely be when the producers run out of short term options to maintain production. And given the size of the production base, it would be difficult for the rest of the global producers to compensate for this pending supply challenge.

This sounds scary to anyone other than oil & gas investors, who are likely salivating at the idea of a supply shortage in the next few years. This is a window of opportunity short enough that alternative energy won't have developed to a point where it is taking a big bite out of oil demand, and one far enough in the future that the short-term thinking on Wall Street could be undervaluing lots of stocks in this sector.

The one counter to Kibsgaard's comment here is that there is still a lot of those longer tail investments still waiting to come online. **BP's** management plans to grow production by an additional 1 million barrels per day between now and 2021. Similarly, **Total** and **Chevron** have plans to increase production more than 4% annually between now and 2020. Some of that will come from juicing production rates from existing fields and from shale, but it does go to show that there is still a rather large inventory of projects yet to become operational that could delay the sharp production decline trend Kibsgaard predicts.

What a Fool Believes

There is another variable that could throw Kibsgaard's predictions on its head: The ability for shale to take up even more slack in the global market. As he mentioned, shale producers today aren't growing with a sustainable model. However, it won't take a return to $100 a barrel — or even $70 a barrel for that matter — for shale wells to throw off fat stacks of cash and make the industry more economically viable. If shale becomes a more profitable endeavor with just a few dollars per barrel increase from today, how much more supply can Noth American shale deliver to the global market?

I don't have an answer to that question, but it will make following the oil industry over the next couple of years fascinating.

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