U.S. Shale Oil Remains a Major Threat to Higher Oil Prices

Description

The decision by OPEC and key non-OPEC oil-producing nations to extend the production cuts established towards the end of 2016 has given crude a solid boost. The North American benchmark West Texas Intermediate, or WTI, is trading at US$58 per barrel, while Brent, the international benchmark, has leaped to US$63. While there are plenty of pundits predicting that greater gains are on the way, including the Russian Ministry of Economic development, several threats to higher crude prices remain.

Now what?

The latest spike in oil prices will spark a surge in U.S. shale oil production in coming months. Not long after the OPEC agreement was extended to the end of 2018, the U.S. rig count rose by six, with two active oil rigs and four gas rigs being added. That number is expected to increase significantly in coming weeks as U.S. shale oil companies move to cash in on higher prices.

You see, despite WTI falling to under US$50 per barrel, production continued to grow. Data from the U.S. Energy Information Administration shows that U.S. oil production for September 2017 reached its highest point since April 2015, despite WTI only averaging US$49 per barrel between October 2016 and September 2017.

It was only a few years ago when such a price would have been catastrophic for U.S. shale oil and an increase in output at such prices would have been unthinkable.

You see, after crude began its precipitous decline in the second half of 2014, companies across the shale oil industry focused on slashing costs and driving efficiencies across their operations to survive the slump. This coupled with technological improvements, according to data from industry consultancy Rystad Energy, has caused breakeven costs for the major shale plays such as the Permian, Eagle Ford, and Bakken to fall to under US$40 per barrel.

The low costs associated with U.S. shale oil are further emphasized by an analysis of second-quarter 2017 financial statements of U.S. shale oil companies by **Reuters,** which showed that the industry-wide breakeven price was US$50 per barrel.

With WTI trading at US$58 per barrel, many shale oil producers are profitable, meaning they will move quickly to ramp up production.

An example of this is upstream oil producer **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE). It derives just over half of its production from its low-cost Sugarkane acreage located in the Eagle Ford and has allocated 70% of its 2017 capital spending to that asset. With Baytex free cash flow positive at US$55 per barrel, it is conceivable that the company will further invest to boost production from that acreage.

One of the largest landholders in the Bakken, **Continental Resources Inc.** (NYSE:CLR), is also among the lowest-cost U.S. shale oil producers. For the third quarter 2017, at an average price of $31.86 per barrel, Continental generated a staggering 66% margin for every barrel produced, highlighting just how profitable shale oil companies have become.

In fact, from the fourth quarter 2016 to the end of 2017, Continental projects that its production will grow by at least 33%, or by over 70,000 barrels of crude daily.

So what?

It is clear that the low breakeven prices for shale oil coupled with the surprise profitability of many U.S. shale oil companies will see a massive uptick in activity in the industry now that WTI has climbed to over US$58 per barrel. That makes the shale oil industry one of the most significant threats to crude rallying higher.

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