OPEC's Quandry: The Double-Edged Sword of Production Cuts

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Three recent headlines from the *Oil Daily*, a well-known trade journal, caught my attention: "The EIA Projection Sees Oil Glut Persisting," "OPEC Already Mulling Cut Extension Into 2018," and "Strong Recovery Lifts Brent Back Over $50."[1] Taken together, these articles capture the transformative change to the nation's energy markets driven by what has been called the shale revolution.

The ability to extract oil and natural gas from shale has been referred to as the most important, and biggest, energy innovation of this century.[2] Geologists have known since the earliest days of oil and gas exploration that large volumes of oil and natural gas lay trapped in fine-grained sedimentary rock, commonly referred to as shale basins. It wasn't until the near turn of the 21st century, however, that Mitchell Energy, a then small independent production company, figured out how to extract oil and natural gas in a profitable manner.

The impact of that event can't be underestimated. Today, the United States produces as much oil as we did in the 1970s. Since the summer of 2011, domestic production increased from about 5.6 million barrels per day to more than 8.9 million per day today and an expected 9.3 million over the coming year, a change largely attributable to increased production from this new found resource. And the EIA recently estimated that domestic production would increase to almost 10 million barrels per day in 2018.[3] This has helped push prices for crude oil (and products such as gasoline) to levels – but for a brief blip with advent of the Great Recession – not seen since 2005. And back then, $50 prices were on their way to exceeding $100 prices. In contrast, for the past two-and-a-half years, we've seen oil remain at or below $60 per barrel.

It is not surprising that the EIA sees the "oil glut" persisting. Mitchell Energy's success unlocked large pools of oil, transforming many of these previously uneconomic oil plays into large underground storage reservoirs. The EIA report is effectively confirming what the market has been telling us – at $50 per

[1] Koster, Frans. "EIA Sees Oil Glut Persisting." Oil Daily. 10 May 2017: 1-2; Bakr, Amena and Oliver Klaus. "OPEC Already Mulling Cut Extension Into 2018." Oil Daily. 10 May 2017: 7-8; and Stewart, Ian. "Strong Recovery Lifts Brent Back Over $50." Oil Daily. 10 May 2017: 4.

[2] Gertner, Jon, *George Mitchell*, New York Times Magazine, 21 Dec 2013 (https://www.nytimes.com/news/the-lives-they-lived/2013/12/21/george-mitchell/)

[3] United States Energy Information Administration. Short Term Energy Outlook. June 6, 2017 (https://www.eia.gov/outlooks/steo/data/ browser/#?v=9)

barrel, there are many more barrels that can profitably be taken out of that storage. Yes, there are other factors at work, as well, such as increasing production from other regions and middling global economic growth. It is worth noting, however, that the process of extracting oil from shale is still in its infancy. Operational improvements, such as longer and more efficiently spaced wells, keep pushing down costs. And cost reductions mean economically attractive reserves at lower prices. Chief Executive Officer of ConocoPhillips, Ryan Lance, recently proffered that at prices even less than $50 per barrel, many investments in shale production provide an after-tax return of at least 10%.[4] Moreover, unlike large offshore operations that take years to bring to fruition, onshore wells can be brought on line in months or even weeks.

It is also not surprising to hear that OPEC is mulling the continuation of its production cuts. OPEC and other non-OPEC producers agreed in December 2016 to remove approximately 1.8 million barrels per day from the market, although actual cuts appeared to be less than that amount.[5] They did this in an effort to stem falling prices and to allow the market to absorb what was deemed to be a surplus of existing production. Such actions, however, represent a double-edged sword. While they surely serve to push oil prices higher than they otherwise would be, they also increase financial ability of producers to extract greater quantities of oil from shale and other producing basins – and, in turn, push oil prices lower. In effect, OPEC's actions offer greater incentive to United States and other non-OPEC producers to pull even more oil from these new found resources.

We have now entered a period where the daily price of oil settling rising back above $50 qualifies as a "strong recovery." And that tells us quite a bit about today's oil market.

The views expressed herein are those of the author(s) and not necessarily the views of FTI Consulting, Inc., its management, its subsidiaries, its affiliates, or its other professionals.

[4] Sattler, Casey and Shani Alexander. "US Tight Oil Resilient to Price Pressure." Oil Daily. 12 May 2017: 1.

[5] http://www.cnbc.com/2017/02/23/us-turns-into-oil-nation-with-record-exports-eating-opec-market-share.html