

From Stalemate to Checkmate: How Shale Continues to Outmaneuver OPEC

OPEC has lost the ability to keep prices in check due to rising production of U.S. shale production.

HOUSTON, TX, USA, May 23, 2017 /EINPresswire.com/ -- Is Riyadh set to become the next Las Vegas?



OPEC is fighting a losing battle against U.S. shale.”

Dan K. Eberhart

The idea that Saudi Arabia’s political and financial capital could someday become synonymous with the American resort city hub seems preposterous.

But the Kingdom, no longer the world’s lever for oil pricing, is so eager to diversify away from its oil-based economy that it

intends to build what it is calling an “entertainment city” on the edge of Riyadh. The as-yet-unnamed attraction will be the same size as Vegas (129 square miles) and will offer cultural, sporting, and entertainment activities, including a Six Flags and safari park.

The attraction is part of Vision 2030, a strategy devised to reduce Saudi reliance on oil. The plan, released last year, depends to a large degree on the success of a partial initial public offering (IPO) of national oil company Aramco in 2018. Although less than 5 percent of the company will be up for grabs and the valuation remains unclear, the company is expected to be worth more than \$2 trillion – which means marketing Aramco could result in the world’s largest IPO. The infusion of funds would help bolster the weakened Saudi economy and provide support to a government so dependent now upon deficit spending that some observers suggest it could run out of money in as little as five years.

However, because interest in the IPO from overseas investors has been tepid so far, higher oil prices remain the Kingdom’s panacea, at least in the short run. And so, on Thursday, Saudi Arabia will slog back to the OPEC conference table in Vienna, almost certain to push for an extension of the six-month production cuts most OPEC members and Russia agreed to in December (Libya and Nigeria are exempt; Iran can actually increase output). Under that arrangement, which was intended to bring supply in line with demand and prop up prices, OPEC’s total oil production has decreased about 1.6 million barrels per day from a high in November 2016. However, there’s a catch, as there often is with things like this: not every OPEC producer is abiding by the output agreement. In March, for example, only five members kept their pledge to cut production. And prior to the accord, several OPEC countries actually boosted production – hence the November record -- so that complying with a percentage decrease actually just returned them to stasis. Saudi Arabia, OPEC’s de facto leader, was the main driver behind the cuts and continues to honor the deal to some degree: it has increased its output since the agreement was put in place but remains under its guaranteed ceiling.

OPEC market manipulations don’t yield intended results

The history of OPEC’s attempts to manipulate the market is well-known, with recent examples including the cartel loosening the tap even as more American shale production came on the market. The price destabilization that followed was intended to drive shale drillers out of business and it did

cause some pain in those quarters, but not the mass exodus that OPEC had hoped for.

Now, the question is: Will extending promises to trim output have the effect on prices that OPEC desires? It could in the short term. After all, the December announcement of cuts did inspire a short-lived rally, when prices rose 20 percent for the first time in years. But that move seemed to benefit non-OPEC producers, most notably American shale drillers, most of all. Shale production ramped up, and, even with prices back down in the \$50 neighborhood, shale drillers continue to disrupt the equilibrium the cartel hoped to restore. The U.S. rig count remains on an upward trajectory. Both U.S. production and exports are on the rise, making it more difficult for a less powerful OPEC to compete.

Dan K. Eberhart, CEO of oilfield services company [Canary, LLC](#), explained, "OPEC is fighting a losing battle against U.S. shale. Recoverable oil in shale plays such as the Texas Permian Basin is steadily increasing over time, which is contributing to higher U.S. output. The economics of production favor the U.S."

Most OPEC member nations cannot withstand crude oil prices in the \$40 to \$50 per barrel region. But for many American shale operators, technological and efficiency innovations have lowered the break-even point well below those ranges. In a report last fall, analyst Wood Mackenzie noted that of 17 large U.S. E&P companies, most could hold production steady at \$50 per barrel without spending beyond cash flow. As the domestic shale industry continues to find ways to lower production, operating costs, and debt, the advantage over OPEC is likely to become even more pronounced.

Through hedging, American producers deal a blow to OPEC

Equally important is the fact that American producers have engaged in aggressive price hedging that insulates them from price volatility. Hedging allows producers to lock in prices now for production that will occur in a year or so; in case of a downturn, the price is protected. Many of the best-known names in the industry are implementing hedging strategies; according to Wood Mackenzie, a third of the largest producers have 26 percent of their output hedged, and much of that occurred when prices were above \$50 per barrel.

"U.S. oil companies hedging strategy means that OPEC will have to bear more of the downside for not extending the production cuts. In other words, OPEC has to shoot itself in the foot twice to inflict the intended damage on U.S. shale," Eberhart continued. "Moreover, the Saudis need a higher oil price for the Saudi Aramco IPO."

But some companies are betting even more on hedging. The Fuse reported, for example, that SM Energy has hedged 80 percent of its oil and gas output for 2017, while also locking in about a third of production for 2018. Whiting Petroleum said it has hedged 53 percent of its production for 2017, according to The Fuse, while Pioneer Natural Resources told attendees of OGIS, the Oil and Gas Investment Symposia organized by the Independent Petroleum Producers of America, that the company has put \$2.6 billion into hedges in the last seven years.

Eberhart said, "The fact is, whatever OPEC decides is unlikely to matter much to shale drillers. Production cuts that increase prices are a good thing; allowing the current cuts to expire will lower prices, but American producers have hedged against that risk."

So maybe it's a good thing Saudi Arabia is planning that entertainment city, with its amusement parks, rides, and contests. Because it looks as if, this time, OPEC has been outwitted at its own game.

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