Fracking Boom About to Bust?

Crude oil prices have dropped below $80 a barrel, down more than 20 percent just since June, meaning price estimates by the U.S. Energy Information Agency (EIA) have been far too pessimistic. And these low prices — and the fear that they could go even lower — are making a number of oil industry people increasingly nervous, with some predicting that the prices are getting so low that oil companies are going to stop new drilling and even cut back on production from already drilled wells.

On October 7, the EIA estimated that prices for West Texas Intermediate (WTI) crude oil will average around $95 a barrel in 2015 while its estimate for Brent crude — the benchmark for more than half of the world's crude oil supply — would be more than $100. With December delivery of oil on the New York Mercantile Exchange at $80.61 on Friday (and touching a 52-week low of $79.10 a few days earlier), the EIA's estimates may turn out to be off the mark by 20 percent or more.

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The drop in demand and the increase in supply, thanks to the fracking revolution (hydraulic fracking coupled with horizontal drilling), is causing consternation locally as well as internationally. Saudi Arabia, the swing supplier in OPEC, at first cut its production earlier in the year by 400,000 barrels per day in a failed attempt to halt the decline in prices. When that didn't work, the Saudis capitulated and cut their prices in order to maintain their market share. This has precipitated a price war as small OPEC members have begun to cut their prices as well.

Locally, Ralph Eads, vice chairman and head of global energy investment bank at Jeffries — a major player in the energy advisory business — expressed his firm's concerns two weeks ago, when oil was still well above today's levels:

> If prices go to $80 or lower, which I think is possible, then we aregoing to see a reduction in drilling activity. [We are] entering uncharted territory.

Ed Morse, Citigroup's head of global commodities research, said in a phone interview two weeks ago that "if prices fell suddenly to $60 a barrel, the production growth [in the United States] would turn negative."

Even T. Boone Pickens, long a noisy but respected investor in energy, expressed his nervousness about oil prices continuing to decline:

> What always happens is you get too much oil and gas and the price gets too cheap and you quit drilling — you can't make money.
>
> [If the price] breaks down … you'll stop the boom right quick.

Even the stock market index of 21 publicly traded oil and gas producers — the SIG Oil Exploration and Production Index — has shown its concern with investors selling off the shares and driving them down from their recent highs by more than 20 percent.

Larry Oldham, an oil investor and former oil executive in Midland, Texas, with more than three decades of experience in both up and down markets, has seen all of this before:

> We're not seeing a real pullback yet. But it if stays this way, you're going to see companies take their foot off the accelerator.
>
> A plane doesn't go straight up forever.

At the moment, however, it's throttle to the firewall, at least for Pioneer Natural Resources, a $12 billion company that's listed in the Standard and Poor's 500 Index. Said Pioneer's COO Tim Dove: "The margins and rates of return on investments [that] Pioneer is currently receiving continue to remain favorable." And the same goes for oilfield services giant Baker Hughes, which tracks the activity from drilling rigs, noting that the number of rigs continues to increase steadily. According to the *Energy Economist* newsletter, the number of horizontal drilling rigs now total 1,353 (as of October 17), an increase of 23 percent in just the last year.

Mark Mills, a Manhattan Institute senior fellow, gave at least three reasons why the fracking boom is a long way from topping out: Production of oil at current prices is still immensely profitable, production technologies continue to make drilling more efficient, and lower prices will force marginal producers to become even more creative in finding oil at lower costs.

Some of those new technologies that have remained on the shelf while the industry has been picking off low-hanging fruit with its present technology include automated drilling; micro-drilling, which speeds up well drilling while making a less intrusive "footprint" on the surface above the shale formations; and vastly improved software that allows them to find the best places to drill. New classes of high-resolution subsurface microseismic imaging are improving the already high success rate in new wells while also making better use of existing ones.

Other factors mitigating against any imminent decline in fracking activity include the fact that many of the larger production companies have already purchased leases and have put wells in place. This means that the only expense is the variable cost of making the well productive, costs that are estimated to be as low as $37 a barrel.

OPEC nations have far higher break-even points, having already counted present oil revenues in their budgets. For instance, Saudi Arabia needs oil at $87 a barrel to balance its budget, while the UAE (United Arab Emirates) needs oil to stay above $66.50 and Iraq needs $93 a barrel. So, despite current conflicts inside OPEC, the cartel will remain highly motivated to do whatever it can to keep oil prices high.

Demand for energy continues to grow apace worldwide even as Europe, Japan, and China struggle with weakening economies. The switch to alternate sources of energy such as nuclear, wind, or solar continues to be very slow and, in the case of wind and solar, immensely expensive and inconsistent in producing significant amounts of energy.

In fact, the price of oil is coming down to the point where Oldham, who sold his last oil company to Samsung three years ago, is thinking about getting back in:

> I think this pullback may create some opportunity. I may end up back in the operating business again, myself.

There is a bottom in oil prices out there and when it happens, entrepreneurs such as Oldham will see the opportunity to buy weak and struggling companies at huge discounts and bring them back to life just in time for the next rise in the price of oil. At present, however, it’s far too early to be calling a top in the fracking boom.

A graduate of Cornell University and a former investment advisor, Bob is a regular contributor to The New American *magazine and blogs frequently at www.LightFromTheRight.com, primarily on economics and politics.*