Governing Energy

Is it Different This Time?

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There is a saying in Texas that goes something like, “This is not my first rodeo” meaning that we have been down this path before. For those who have made their careers in the upstream oil and gas sector, riding a bull may be tamer than adjusting to the ups and now downs of the crude commodity price points.

Industry response includes organizational restructuring, reduction in force, divestitures and acquisitions, office consolidation and so on. Of course, these and other actions are currently underway.[i]

Another refrain often heard in times of market chaos, “This time is different.” Not surprisingly, this statement is routine overstated or even false.[ii]

However, there is an argument emerging that perhaps this time, the crude oil market drivers may be different. Pundits are positing that the North American shale oil revolution and its global potential are fundamentally new (different) economic drivers.[iii] A corollary position is that major historic suppliers of crude oil have launched a price war in an attempt to defend market positions.[iv]

If one assumes that these two premises are correct (*over* supply driven), sustainability and/or attaining the position of low cost producer will determine success. Roughly, this argument goes that shale finding and production costs are higher. If that is the case shale and perhaps other unconventional sources may fade in the face of determined market actors.

The counter position emerging is that shale and even production of heavy Canadian crude are actually the low cost producers. While still in flux, it is becoming increasingly apparent that shale oil production cost may be significant lower than previously believed.[v]

Perhaps even less understood is the position Canadian heavy oil producers have that they can operate profitably at much lower prices. At a high level, this extraction process has a high capital cost (CAPEX) similar to building a downstream refinery (new ones have not been built in years but they are constantly upgraded) which is a process manufacturing facility.

Existing heavy oil process manufacturing capital investments are already sunk cost—new ones on hold. Moreover, these facilities can have decade’s long production life with current cost around $35 per barrel or even less.[vi] This mirrors downstream production where cost management is a Key Performance Indicator.

Additionally, engineering and service contract prices are falling in response to market realities. Finally, technology is credited with playing a significant role in the low breakeven price.[vii]

Previous oil bust cycles are usually followed by market recovery. However, if the true industry production cost for unconventional crude is below $35 per barrel on a sustainable basis, then it may be *different this time*.

There is a contrarian perspective to these hypotheses—this is just another cycle driven by over production and "this too will pass."[viii] Time is the only variable that will determine whether there is a fundamental change in global crude markets or if this is simply one more boom—bust cycle.

However, successful economic actors will not depend on the old oilman's prayer, "Lord, give me one more boom and I promise not to screw it up this time.'' Those that help themselves will take charge and position their organizations accordingly.

There has been a discussion for at least a decade or two that the great promise of Integrated Operations, aka Digital Oilfield was the evolution of the oilfield from one of a historic mineral extraction, high-risk set of activities to one of the *field as a factory*.[ix] In other words, process manufacturing.

Global oil and gas markets are susceptible to more diverse, complex and integrated variables including geopolitical risks than addressed herein. However, if unconventional operators are the low cost producers, then the market game has fundamentally changed.

How is your company positioned if it really is different this time?

About the Author

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End Notes

[i] http://www.ogfj.com/articles/2014/12/bp-to-spend-1b-on-restructuring-and-job-layoffs.html
[ii] http://www.nber.org/papers/w13882
[iii] http://www.voxeu.org/article/shale-oil-and-gasoline-prices
[iv] http://www.marketwatch.com/story/can-saudis-beat-north-dakota-in-an-oil-price-war-2014-10-08
[v] http://en.wikipedia.org/wiki/Oil_shale_economics
[vi] http://www.wsj.com/articles/as-oil-slips-below-50-canada-digs-in-for-long-haul-1421114641
[vii] http://www.cnbc.com/id/102234051
[viii] http://oilprice.com/Interviews/The-Real-Cause-Of-Low-Oil-Prices-Interview-With-Arthur-Berman.html
[ix] http://www.energistics.org/Assets/nov04ammsshemwell.pdf