Falling oil prices test shale boom

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In recent weeks, the price of oil has dropped significantly on a global basis.

The drop in price is the result of a glut in supply, caused in part by rapidly increasing U.S. oil production from shale formations, combined with tepid global demand. So far, no producers have indicated any intent to make large-scale cutbacks in production in light of the reduced price. This means that prices may head even lower and persist for longer, as production continues to exceed current demand. If the lower price prevails for an extended period of time, the economics of extracting oil from higher cost sources (including shale formations) could become less attractive, at least in the short term. This might result in reduced drilling or production activities.

Industry participants should consider carefully what a sustained price drop could mean for their own individual operations. Persistent lower prices are likely to benefit refiners of petroleum products. On the other hand, exploration and production (E&P) companies and those companies that service the E&P sector will be hurt by lower prices. In particular, industry participants that are heavily financially leveraged could be substantially impacted by prolonged low prices.

During prior periods when energy prices dropped dramatically (such as the mid to late 1980s), many marginal players (E&P companies and other companies servicing the oil sector) suffered greatly. On the other hand, production from shale wells has been improving for some producers and costs for shale oil production are also dropping for many U.S. producers. As a result of these productivity gains, the current boom in U.S. production is allowing domestic producers to take market share (at least at present) from some foreign suppliers, which will likely allow stronger industry players to remain strong, if even low prices persist.

Industry participants may wish to assess more closely the economic viability of their business partners and their partners' viability if low prices persist. Industry players considering new deals should consider whether new or different contract terms are necessary or advisable in light of the current pricing conditions. Finally, participants should also consider closely the use of debt financing for their operations and how it might adversely impact them if low prices persist for a significant period of time.

In any event, while current low prices may impact short term returns on investment, it is quite unlikely that the low prices will impact the current boom in U.S. oil production in the long run. The long term outlook for shale oil continues to be extremely bright.