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OPEC Just Did American Shale Drillers a Big Favor

OPEC and Russia just gave their most implacable foe, U.S. shale, an early holiday gift.

As corporate boards for American oil explorers prepare to sketch out 2018 drilling budgets, Thursday's historic agreement by Saudi Arabia, Russia and other major crude producers to extend supply caps for another year may prompt directors to spend more on drilling. That's because the producer group's restraint has meant higher prices for U.S. shale drillers, who haven't been shy about hiring more rigs or flooding global markets with more cargoes.

After climbing out of a crater dug by the worst oil-market collapse in a generation, North American explorers probably will boost spending by 20 percent next year, according to an Evercore ISI survey of industry budget trends. That would follow an estimated 41 percent jump in 2017.

"The North American E&P industry is very itchy to spend more capital dollars," said James West, an Evercore analyst who's recognized as the keeper of the keys to North American spending data going back to the mid 1980s. "They're in the board rooms right now talking about budgets and OPEC is saying what they're going to do through 2018."

The timing of the announcement from OPEC and its Russian ally was no doubt helpful to American drillers, West said. The prolonged nature of the extension that had been due to expire in March will reassure oil traders and provide investors and executives alike with a degree of comfort about price stability, he said.

Even as next year's drilling budgets are in flux in the c-suite, explorers already are poised to ensnare any price blips stemming from the OPEC-Russia deal. When crude prices rise, shale producers typically use financial instruments such as swaps and options to lock in prices for barrels they won't pump until months from now, a process called hedging.

Hedging Output

"OPEC's decision helps to underpin the forward curve and gives shale producers the opportunity to tie up more volume in hedges," Scott Hanold, an Austin, Texas-based analyst for RBC Capital Markets LLC, said in a phone interview.

Right now, producers probably can secure hedges based on the U.S. benchmark, West Texas Intermediate, that provide a floor in the low to mid $50s a barrel, Hanold said. "I would guess that a lot of hedges have been going in" since the deal extension was announced, he said.

About 60 percent of the expected production by companies in RBC's coverage universe is already hedged, "a much fuller hedging book than in previous years," said Hanold. Still, there's room to do more, he said.

For more on oil hedging by shale drillers, click here

To assuage investors demanding that shale explorers live within their means and forego drilling wells with borrowed money, West said he expects companies initially to announce budgets based on more conservative estimates of around $50.

Dynamic Budgeting

"But it wouldn't surprise me to see the overall budgets for North American companies especially, given how dynamic they can be, to move up throughout the year," he said.

Andre Burba, partner at the New York-based investment firm Pine Brook Road Partners LLC, said he doesn't expect a material revision in drilling budgets based upon the OPEC-Russia decision. Rather, it's affirming their original plans before the OPEC meeting.

"The decision is adding much needed stability to this nascent recovery that we've seen over the course of the last year," Burba, whose firm's $4 billion under management includes a portfolio of about a dozen North American explorers, said Friday in a phone interview. "Adding that element of stability and given the time frame of this extension, it was a very very helpful step."

Too Rich

Ultimately, shale’s voracious appetite for growth may very well eat the rally that allowed it to grow in the first place. If output from U.S. shale fields continues expanding next year on the back of OPEC’s asceticism, individual discipline will slip, member nations will abandon the alliance, and a new price-killing glut will emerge, according to analysts at ESAI Energy LLC.

“What tastes good today will become too rich later in 2018,” the ESAI analysts said in a note to clients. As shale output escalates, “the deal will begin to quietly unravel. This means higher prices in the short-term, but lower prices by 2019.”