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When Will The Price Of Oil Hit Bottom? The Market Is Looking At The Wrong Number.

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Ray Gerish, a floor hand for Raven Drilling, works on an oil rig drilling into the Bakken shale formation outside Watford City, N.D. (Photo by Andrew Burton/Getty Images)

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Plunging oil prices have taken the punch bowl away from the U.S. unconventional [energy](#) party. So what happens next? The answer is to be found in a single calculation: whether the commodity price exceeds the cost of production. No one is ready to call a bottom at this point, but with U.S. prices now in the \$40s, all rational thought on this topic must go to

determining the ever-elusive cost of production in the shale-rich regions of North Dakota and elsewhere. Not long ago, that number was believed to be \$70, but production continues. Some observers have pointed to long-term price guarantees, others to improved efficiency in production. Both are valid and help explain the current continued production.

In my view, however, the market is focused on the wrong number. The meaningful number in the long term is not the cost of production but the incremental cost of production. Total production costs include capital investment, which includes rights acquisition, infrastructure, equipment costs, drilling and other up-front expenses.

Once any long-term purchase agreements expire, it is possible that many operations are under water—de-equitized and the leverage subject to a haircut. That said, all in the initial investment remains in place. Unlike the “see-through” buildings of the mid-1990s, which had no takers for the space, there remains a market for oil and gas, at least for now, just at lower price points, and as long as the price of the product remains in excess of the incremental cost of production, production will continue.

So what is the incremental cost of production? It is the minimal operating cost to continue to produce without regard to the investments previously made. Specifically, it is maintaining a minimal crew, the purchase of necessary materials, and whatever else it minimally takes to get the product out of the ground and to markets. What is this number? It will depend upon the well in question, the specific local market for labor and the cost of materials, so it will differ from region to region and well to well. Perhaps the number is \$30, which leaves enough room for some additional development, \$20 a barrel or even lower, for continued operations at fully developed sites. Indeed, with the slackening of activity as a result of the abandonment of marginal wells and scrapping of plans for additional development, these operational expense components should start to fall from reduced demand.

The real numbers come not from [Wall Street](#) bankers in custom suits but from the folks in North Dakota wearing long underwear in the sub-zero weather now gripping that region. One seasoned player recently told me that the current number to keep oil flowing from an average operating Bakken well is just about \$23 a barrel—a far cry from the \$70 number being used by analysts just a few months ago. A veteran oil field service provider recently assured me that even that number could fall as lowered demand leads to more aggressive pricing for services.

Owners, or their restructuring officers, lenders or successors in ownership after creditor proceedings, will continue to produce. Indeed, just as many conventional producers are pumping more now to mitigate the impact of lower prices, lower prices may actually work to increase pressure to produce more from unconventional fields, as capital providers push to recover value from their collateral.

Is this a buy opportunity for investors? Certainly. Assuming a price point that reflects the current market—a meaningful markdown of the assets—the risk is the same one that always exists in the extractives industry: extraction cost vs. value of the extractive product. Of course the narrower spread doesn't provide the warm and fuzzy feeling investors like to find. But at this point, it would also not be absurd to consider the possibility of a recovery in the market.

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