Forbes

http://onforb.es/1Bf999W

Energy Source

We cover how we power the world.

Opinions expressed by Forbes Contributors are their own.

ENERGY 1/21/2015 @ 4:06PM | 2,566 views

Why Oil Could Pop Up To $70 In The Mid Term

Forbes Staff , Contributor
Comment Now

Pump jacks and wells are seen in an oil field on the Monterey Shale formation near McKittrick, Calif. (Photo by David McNew/Getty Images)

GUEST POST WRITTEN BY
Joel H. Moser
Mr. Moser is the founder and CEO of Aquamarine Investment Partners, a real asset fund focusing on energy, infrastructure and real estate.

Oil will go up: $70 seems to be a fair mid-term target. But first, here's why it may still come down.

I recently wrote that Bakken players are telling me that the incremental price to keep pumping at a fully developed well is $23 a barrel, so anything above that number keeps that well producing, if only to realize value on the collateral for capital providers. That's all about the net current cash flow on

these wells. Contrast that to the $60 figure that is probably the all-in–including capital costs–number for the best producers in the best locations to operate these businesses.

There is a similar phenomenon playing out in the oil sands of Canada, and indeed anywhere that there has been an investment already made in extraction: These wells can and will be made to produce oil at substantially below the all-in cost of that production. So production will continue from these new sources, perhaps even increase a bit to make up for losses in the price — for a time. But what is that time frame and what happens when it is up?

Another number to remember is 18 months. That is believed to be the length of time that a typical operating shale well can produce before requiring more capital investment — additional drilling, which may itself require additional investment in infrastructure and equipment. Oil sands fields are thought to have greater longevity before requiring further investment.

So while $30 oil may not fully stop unconventional production, there would come a moment, even at the current mid-$40s prices, that decisions would be taken that will significantly reduce the flow. At that point the condition of slight oversupply in the market would start to balance and prices would likely stop falling.

So why do I think $70 is a reasonable target and not $30? A few comments on why the price is where it is now and who is actually getting that price. All the oil in the world currently being stored and used was not purchased at the current levels. Not the oil in the tanks of homeowners who entered into price protecting long-term contracts and not the oil being refined at facilities that hedged the price or, for that matter, for oil temporarily held by commodities traders who hedged prices a few months ago.

Think of a homeowner who recently stocked his garage with firewood at $250 per cord. Just then a tree service operator drives buy his house and asks him if he wants to buy some wood he just cut. As long as he has enough space for some more wood, the homeowner might say, “maybe, at what price.” At $250, he would probably say no, since he’s stocked for the year and doesn’t feel like moving the boxes of Christmas ornaments around. But if the ask comes back at $50, he might say yes since he will eventually use it.

That’s more like the price now being quoted: the price for the extra oil literally floating (on ships or rail cars) around the market. But it’s not that simple. Imagine that there are a few fellows down at the end of the street who have a card table and they bet on how much that homeowner, and others, will pay for a wood delivery in a month from now or so, and they just heard that this homeowner paid $50 bucks or, even worse, the truck drove off without selling a stick. Some of those fellows are now betting on even lower numbers. That’s more like what is underlying the current trading prices. Plus the fact that the speculators have also been hedging so there will be a period of time

that even the hypothetical trading market is dealing with the dual reality of the prices being paid under prior hedges and the current prices in this lowered environment—they are speculating on only the most current bets.

There will come a time, and it may well follow even lower levels, that both the hedges expire so that the whole market is back at it, and the 18-month or so production period on many unconventional wells ends, so that the ongoing shale-based production cost rises to $60 from $23. At that point there is a distinct likelihood that a new equilibrium will emerge between supply and demand, with significant production capability being idled.

What about real global demand, as distinct from trading demands? Growth has slowed but there is still growth, and there are murmurings of some possible sparks here and there, so real demand is also likely to rise, balancing the increased production. As prices start to rise, some of the extra production, both conventional and unconventional, that was squeezed out to make up for the fall in prices will start to slow down, again possibly easing to an equilibrium. Shall we say at $70, which supports profitable production of some, but not all, unconventional oil at levels that global consumption was absorbing before the glut that was created at the $100 plus levels?

So what is the date that pairs with this (fairly unremarkable) price point suggestion? I frankly don't put much faith in any of the more specific prognostications because there are also policy inputs to this math and government action is unpredictable. Without even going to the conspiracy theories of revenge pricing from one source or another, simply consider a Republican majority Congress considering the issue of preserving America's energy independence, as well as regional jobs. It would not be inconceivable for a proposal to emerge that directly, or indirectly in the tax code, supports U.S. domestic production. And most other oil-producing nations have many other levers to push that can manipulate production. This is not a purely private sector market, so no math can fully reveal the future. Finally there is always the potential for geopolitical risk that disrupts supply and spikes prices.

So there you have it. $30 to $70, for some time frame, I'm not saying when.

Joel Moser is the founder and CEO of Aquamarine Investment Partners, a real asset fund focusing on energy, infrastructure and real estate. He is also an adjunct professor at Columbia University School of International and Public Affairs, a member of the Council on Foreign Relations and a founding member of the Advisory Board of the Columbia University Center on Global Energy Policy.