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COMMODITIES | Fri Feb 17, 2017 | 10:16am EST

U.S. shale oil braces for the unfamiliar in 2017: inflation

Exploring the Road to Inflation Protection When Energy Fails

In our recent paper, Let's Get Real About Indexing Real Assets, global real assets are defined for the first time in an index. The index includes a complete set of liquid real assets (infrastructure, property, natural resources, and inflation bonds) that have been blended using equities, fixed income, and futures. The results demonstrate that the S&P Real Assets Index may provide inflation protection and improve diversification when added to a mix of U.S. stocks and bonds.

The following analysis shows how real assets may provide inflation protection and affect portfolio

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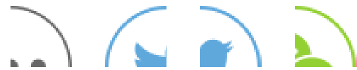

By Swetha Gopinath and Arathy S Nair

U.S. shale producers are facing their first production cost increase in five years in 2017 as industry activity picks up and energy service providers hike fees to take a bigger share of the profits generated by higher oil prices.

Drilling innovations over the past decade have generated a dizzying reduction in the cost of pumping oil from shale formations across the United States - the world's largest energy consumer - triggering an energy revolution and a production boom.

When that boom ended with the onset of a two-year global price war in 2014, shale producers responded with even deeper cost cuts. Technological breakthroughs allowed producers to wring more oil from the rock and halved the per-barrel price needed to turn a profit.

But for the first time since 2012, shale producers will see a rise in break-even production costs this year, according to data from Rystad Energy, which surveys producers. The per-barrel costs will rise an average of $1.60 across the shale patch to $36.50.

For a chart of the fall and recent rise of shale oil production costs, see: tmsnrt.rs/2lxKeeX

The drive to lower costs has run its course for now, and service firms are leveraging power in the more crowded oilfields, such as the Permian basin in West Texas, to eke out higher payments from producers.

Firms that supply rigs, crews, technological expertise are clamoring to take back discounts they extended during the slump, in some cases asking for between 10 percent and 15 percent more as the number of rigs and crews deployed in the fields rises.

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Producers expect that to continue.

"In the Permian, activity has picked up, and going forward we would expect to see some pressure," Chevron Corp's (CVX.N) Chief Executive John Watson said on an earnings call last month.

Oil service providers acknowledge, however, that their price hikes may not stick until drillers generate enough demand to burn through the remaining spare capacity in the oil service sector.

In a securities filing on Feb. 8, service provider Baker Hughes Inc (BHI.N) cautioned that drilling "activity needs to increase meaningfully before excess service capacity can be substantially absorbed and meaningful pricing recovery takes place."

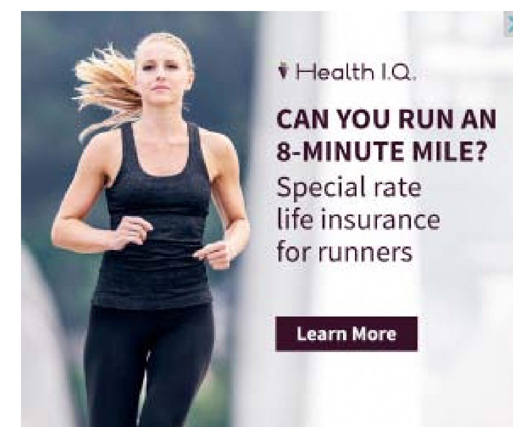
PERMANENT COST SAVINGS

Service inflation represents only a fraction of the expected rise in international crude prices this year. A Reuters poll of 31 analysts and economists forecast benchmark U.S. oil prices will average $56.08 per barrel in 2017, up from $43.47 last year.

Between half and two-thirds of the cost savings achieved during the oil price slump are likely to become permanent even if oil prices tick higher, according to industry experts and company estimates.

Shale companies deployed more rigs than they have done in sixteen months last week, and have steadily increased the number in the field to take advantage of crude prices that have mostly held at more than $50 per barrel since the world's top oil exporters, both OPEC and non-OPEC, agreed to cut supplies in late November.

A further rise in the oil price could quickly stir drilling activity across the United States, which would in turn accelerate service fee and labor cost inflation. That is a worrying development for an industry that has lately gotten used to costs heading only down.



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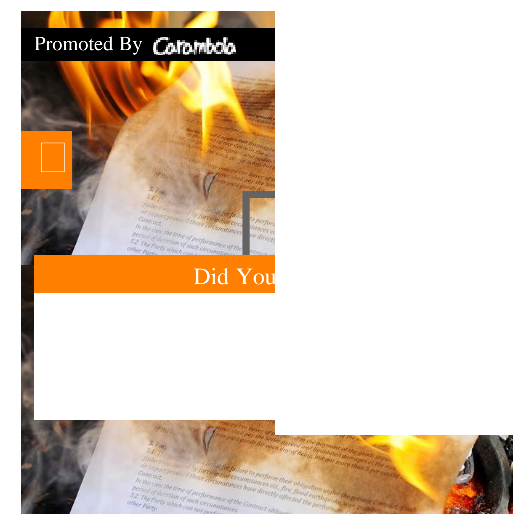

There were 207 hydraulic fracturing fleets at work in January across the U.S., up 20 percent from last June, according to data from Houston-based Primary Vision, which tracks oilfield service equipment usage.

Pioneer Natural Resources Co (PXD.N) has its own fracturing crews, which it hopes will help offset rising service costs elsewhere.

"I believe we will be able to keep our inflation numbers down to more like approximately 5 percent, but the internal plan is to make sure that cost inflation is offset by our efficiency gains," Pioneer Natural Chief Executive Tim Dove said on a post-earnings call earlier this month.

HEDGING AGAINST INFLATION

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Other companies have locked in contracts to insulate themselves from the rise in service and labor costs. WPX Energy, a leading shale oil producer in North Dakota and Texas, has sought to protect against price inflation through contracts for sand, stimulant, equipment and services, said CEO Rick Muncrief in an interview.

Other companies including Hess Corp (HES.N) hope to beat the inflation forecasts with yet more efficiency gains.

Hess hopes to wring more barrels out of each well with new techniques that allow it to conduct hydraulic fracturing at 60 spots along a well, up from the usual 50, president Greg Hill said on a conference call last month.

In addition, using more sand and other proppants - used to keep fissures in shale rock open - in the wells should help boost production, Hill said.

Oil producers can already count on many cost savings achieved in recent years, such as reductions in the time it takes to drill wells, said Gürcan Gülen, an energy economist at the Bureau of Economic Geology at the University of Texas at Austin.

"Once you know better how to do things, you're not going to change that when oil prices move higher," said Gülen.

But the possibility of more deep cost reductions are, for the most part, gone.

A number of companies saw break-even costs at the wellhead - the price required to profit from oil at a new well - stagnate between the third and fourth quarters, data from Rystad Energy showed.

"To certain producers, there's a little bit of opportunity to lower costs more," said Bill Costello, a portfolio manager at Westwood Holdings Group. "But those are few and far between."

(Additional reporting by Ernest Scheyder; Editing by Gary McWilliams, Simon Webb and Brian Thevenot)

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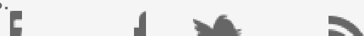

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