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What Is the "True Price" for Oil?

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The past 15 years have been a roller-coaster ride for oil/gas prices. We've seen oil as high as $140 per barrel (July 2008) and as low as negative $37 per barrel (May 2020). While today's bull market is a welcomed development for exploration and production (E&P) companies, as well as financial advisers seeking to guide their energy-minded investors, history teaches us that extreme caution is required in terms of setting our pricing expectations and, ultimately, our E&P investment underwriting.

So, what is the true price of oil? Does today's spot price of $110 per barrel (bbl) make any sense? What about the pre-COVID oil price of $60 per barrel (WTI average, January 2020)? Is it some place in between? Perhaps we should look at what those close to the E&P industry are making of it.

Market fundamentals pre-Ukraine conflict

Before we examine what the E&P sector is thinking, let's examine where the oil market stood prior to the invasion of Ukraine.

What was forecast by Wall Street, the U.S. press, and (quite frankly) the Biden administration faithful as doom, disaster and the end of the oil business in mid-2020 turned to tentative optimism in mid- to late-2021. The reason for this shift was simple economics. In his market podcast on February 5, 2022 (i.e., three weeks prior to Russia's invasion of Ukraine), Dan Steffens, president of the Energy Prospectus Group, stated that the "global oil market is tight and is probably getting tighter" in the future. Some points mentioned in support of his optimism:

- COVID was beginning to loosen its stranglehold on the U.S. and world economies, as travel restrictions were being lifted in many countries;
- OPEC+ was not keeping pace with its published quota increases (with the shortfall being 790,000 bbls per day in December 2021);
- Petroleum inventories were at an unhealthy level of 28 days of consumption (with 30 days being a reasonable safety threshold in the view of many); and
- The world was using more oil in 2021 than it produced (with the spread being 1.5 million bbls per day through all of 2021, which is particularly impactful now that Russian exports are constrained).

Pre-Ukraine, Steffen's optimism was shared by Raymond James, which published a pricing expectation of $70/bbl to $80/bbl for 2022 (in December 2021), and with its year-end 2022 forecast of $80/bbl expected to remain through 2023. According to Raymond James' pricing analysts, oil prices "need to move meaningfully higher" to incentivize supply growth to reach a balanced oil market in 2022 and 2023.

And then ... the Ukrainian invasion came

On February 24, 2022, Russia invaded Ukraine in a major escalation of the Russo-Ukrainian conflict that began in 2014. Internationally considered a war of aggression, it represented the largest assault on a European state since World War II. The invasion caused the largest refugee crisis in Europe since the Nazi invasions of the same territory 80 years prior, with over 3.4 million Ukrainians fleeing their country. The invasion of Ukraine violated the Charter of the United Nations and constituted a crime of aggression according to international criminal law, raising the possibility of prosecution under universal jurisdiction.

This aggression incited the U.S. and others to sanction Russia by banning Russian oil imports into their countries. This also led to a significant further contraction of the world's oil supply, as Russia previously exported about 5 million bbls of its oil production daily (i.e., 6 percent of the world's supply). This led to an oil pricing environment unseen since mid-year 2014, with the Brent price hitting $130 per bbl for the first time since 2008. The aggression also led world E&P leaders, such as BP and Shell, to divest their Russian oil investments (although Russia has been able to mitigate some of the sanctions by selling oil to China and India). Ironically, this is not the first time in recent years that Russia played the role of the oil pricing "disruptor."

2020 Retake – Russia the Disruptor (Act One)

When a realization took hold that the COVID pandemic wasn't going away, members of OPEC, led by Saudi Arabia, came together to discuss their plans to mitigate the financial impact. In response to the COVID problem, OPEC's members initially agreed to cut their oil production by about 1.5 million bbls per day. The rationale in doing so was that it would keep crude prices higher and relatively stable so that E&P companies could at least hit their "break evens" during the pandemic.

Russia, being historically aligned with OPEC, was expected to agree with the deal. In a move to prevent U.S. shale oil companies from increasing their market shares, however, Russia announced that it would not abide by OPEC's solution. Assuming the role of the "evil pricing-disruption villain," Russia then announced that, as of April 1, 2020, it would remove restrictions on its national oil production to compete with U.S. shale oil producers.

This is where the oil pricing fallout during COVID became incredibly messy, as OPEC completely restructured its pricing strategy. In response to Russia's non-cooperative posture, Saudi Arabia announced that it would produce an additional 10 million bbls per day and grant price cuts to its preferred customers. Not surprising, the fallout of this followed basic "Economics 101" supply and demand fundamentals. Oil inventories that were already stretched to capacity were flooded with more product. Adding insult to injury, the pandemic forced airlines to cut their flights, businesses to close, and people to hunker down at home. As a result, oil consumption dropped from about 100 million bbls oil per day pre-COVID (2019) to about 92 million bbls per day during COVID (2020). Not surprising to some, the fallout in crude demand led to lower prices in Q2–Q4 of 2020 (with the spot price dropping below $0 bbl in May 2020).

Fortunately, as COVID loosened its grip upon the world last year, oil prices came back to a level around $60 to $70 bbl. In turn, the U.S. E&P sector began to remobilize its activities.

What does the E&P sector make of this?

For the moment and assuming drilling cost inflation remains within certain boundaries, today's oil market presents opportunities for U.S. E&P companies to recapture their profits lost during COVID by increasing their drilling and production. An illustration suggesting how much profit can be recaptured by E&P producers is shown within the following table (with breakevens reported on a "per bbl" basis):

Breakeven points

Play	Avg. break-even drilling	Avg. price to recover operating costs
Permian-Midland	$46	$27
Permian-Delaware	$49	$26
Permian-Other	$53	$33
Eagle Ford	$46	$17
Other U.S. Shale	$58	$33
Other U.S. Non-Shale	$53	$34

Source: Federal Reserve Bank of Dallas Survey, report updated Feb. 3, 2022

Based upon the findings of a recent upstream industry survey published by the Federal Reserve Bank of Dallas (February 3, 2022), many E&P companies are, in fact, gearing up to increase their drilling over the next 12 months. Within the survey of executives from 131 oil/gas drilling and field service companies, the average forecasted oil price for year-end 2022 was $74.69 per bbl, with 75 percent of the survey respondents using oil pricing forecasts of $55–$75 per bbl to plan their drilling capital strategies for 2022 (with a pro forma pricing average of $64 per bbl used for drilling cost planning purposes, thereby suggesting a "true price" that is much lower than today's spot price). Coincidentally, and based upon their viewpoints about future prices and the prospects for profit recapture, a substantial majority (i.e., 78 percent) of the executives from the surveyed drilling companies stated that their companies intend to increase their oil/gas production over the next 12 months. This viewpoint is in fact playing out, with U.S. rig counts increasing at a significant clip over the past year (which has led to a moderate increase in daily U.S. oil production because completions are often delayed several months on wells).

Year-over-year change in production

	Today	One year ago
Rig Count	663	411
Daily Oil Production	11,600 bbls	11,160 bbls

Sources: Baker Hughes Rig Count (March 18, 2022); Energy Information Administration

While there are forces that serve to temper the E&P sector's motivation to drill (e.g., the ESG movement and Wall Street's attitude that E&P companies should use cash flow to pay dividends rather than drill more wells to enhance reserves), there is evidence to strongly suggest that drilling activities are eventually going to help equalize today's oil supply-and-demand problem, which will help to bring oil prices down to a level consistent with the E&P sector's expectations.

Conclusion/Outlook

As many astute oil company leaders have said time and time before, the "cure" to high oil prices is higher oil prices (i.e., leading to more drilling and eventually more supply to help bring the prices down). While many of us will agree that the oil market was well positioned to rebound in 2022, few of us anticipated the "Russian disruption" that surfaced in late February 2022. How long this disruption continues remains a mystery.

As the mystery unfolds, however, we would be well advised to take notice of the cautious optimism of the E&P sector itself in terms of its pricing expectations. Unlike U.S. real estate, oil investing is heavily dominated by world events well beyond our ability to control, such as the Ukraine conflict or the resurgence of COVID in China placing some recent downward pressure on oil demand and prices. Assuming the Russian-Ukrainian conflict stabilizes, how long will it take for Vladimir Putin or perhaps another discontented world leader (e.g., Iran/Iraq) to shake things up again? Cautious optimism is warranted.

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