U.S. shale cowboys do the unthinkable and bring mighty Saudis to their knees

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The oil war is pretty much over, and Saudi Arabia lost.

How did the world's most powerful oil producer, which set prices for decades by riding herd over the member states of the Organization of Petroleum Exporting Countries, get it so wrong?

In a word: shale. The Saudis underestimated not only the strength and flexibility of the American shale-oil industry, but also that of the financing machine behind it. American capitalism proved to be the superior fighting force.

The Saudis sat uneasily for a decade as they watched the shale-oil industry go from technological curiosity to production juggernaut, propelling the United States into the global energy big leagues. At last count, total American oil production (from conventional, offshore and shale wells) was about 9.2 million barrels a day, not much less than that of market leaders Russia and Saudi Arabia.

Their global market share withering, the Saudis lost all patience and finally snapped a year ago. Production would not be reined in to prop up prices. Saudi Arabia and any other OPEC member with spare capacity opened the spigots and a flood of oil sloshed through the global markets. In mid-2014, oil was trading at $100 (U.S.) a barrel or higher. By the start of this year, it had fallen to $30, a price that was transmitting pain to every sector of the oil industry.

Capital expenditures declined from $700-billion (U.S.) in 2014 to this year's estimated $400-billion, according to the energy consultancy Wood Mackenzie. The weakest OPEC members went into economic free fall; Venezuela is on the verge of collapse. Expensive production projects in the North Sea, the Canadian oil sands and other high-cost areas were put on ice and share prices got slaughtered. Hundreds of small oil companies went bankrupt. The survivors, big and small, launched savage cost-cutting exercises as their bankers got twitchy.

But guess what? A few American shale companies didn't make it, but the vast majority kept pumping away. As a result, overall U.S. oil production (including shale) fell by only about 500,000 barrels a day this year over last year.

Much to the Saudis' regret, the shale companies proved remarkably resilient. Falling prices triggered an all-out innovation exercise that, combined with squeezing suppliers and labour, saw production costs sink by an astounding 40 per cent since 2014, dropping the break-even price.

While the flow of capital to the shale industry fell, it did not disappear. Earlier this year, as prices recovered somewhat from their January lows, small American (and Canadian) exploration and production companies had little trouble raising equity financing. Last week, Extraction Oil & Gas of Denver raised $633-million (U.S.) in an initial public offering, the first oil IPO of the year.

Faced with the extraordinary adaptability of the shale industry, and watching is own finances deteriorate at an alarming rate, the Saudis cried uncle last month. At a meeting in Algiers, the OPEC countries (except for Libya, Nigeria and Iran) tentatively agreed to a small production cut to prop up prices. While infighting could wreck the deal, the details are supposed to be agreed next month at OPEC's Vienna meeting. In reality, it is the Saudis who will have to do most of the cutting.

The reluctant U-turn by the Saudis – a signal that managed supply was making an inglorious comeback – immediately sent prices soaring. By Friday, there were up about 15 per cent, to almost $52 (U.S.). "We are at the end of a considerable downturn," Khalid al-Falih, the Saudi Energy Minister and Saudi Aramco chairman, declared at a recent oil conference.

The good news for Saudi Arabia is that the rising price will remove some of the financial pressure on its budget. The bad news is that the Saudis will need a much higher price to clear its budget – the International Monetary Fund put the fiscal break-even price at $79.70 a barrel (though that's a big improvement from the $92.90 needed in 2015). The really bad news is that the inevitable rebound in U.S. production seems likely to prevent oil from reaching that level any time soon.

The U.S. drilling rig count, which fell by about 80 per cent during the oil crash, is up by a quarter since the late spring alone. American oil companies are raising money again and making plans to lift output. Meanwhile, Iran plans to raise production as does Libyan National Oil Corp., whose stated goal is to bump output from the current 550,000 barrels a day to 900,000 by the end of the year (some analysts don't believe it will get anywhere near that target, because of pipeline blockades, lack of funding to repair busted oil fields and general nastiness in a country with three competing governments).

The Saudis have learned the hard way that the oil industry's spare capacity reserves are shifting from OPEC to the United States, where shale-oil production can be dialled up and down virtually at will. Saudi Arabia is running a 10-per-cent budget deficit, its economy is close to recession and, for the first time, it is selling bonds on the international market to shore up its finances.

Its effort to shatter the U.S. shale-oil industry failed badly and, for that, it must overhaul its economy in a hurry if it is to avoid a downward financial spiral and perhaps social unrest.

Only a few years ago, it was impossible to imagine that the cowboys running the American shale-oil drillers would bring the mighty Saudis to their knees.