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GLOBAL OIL: OPEC – BLOWOUT OR BUSTED?

Executive Summary

- If the deal is adhered to then it is significant and will see the global oil market fall into under supply through 2017. This should draw down inventories and create a healthier backdrop for medium term prices.

- There is healthy skepticism that countries will be able to resist cheating on their agreed production levels though and how effective the new monitoring board will be in ensuring compliance. Compliance by Non OPEC countries such as Russia will also be critical, especially given the reliance on individual companies operating in those countries to follow the government's position. The financial pressure of low oil prices in recent years may or may not be sufficient to leave participants with the feeling that they have no option but to comply.

- We now expect oil prices to remain above $50 (Brent) for the first half of 2017 with prices after that dependent on the U.S. supply response.

Following the announcement of a joint deal by OPEC and a group of non-OPEC countries to restrict the production of oil supply in Q1 and Q2 2017, members of our global oil team, Daniel Forgie, John Vail, Johnny Russell and Simon Down discuss the events. This follows the team's earlier prediction that markets were underestimating the chances of a deal being struck.

Global Oil: November Could Be Critical

https://en.nikkoam.com/articles/2016/11/global-oil-november-could-be-critical

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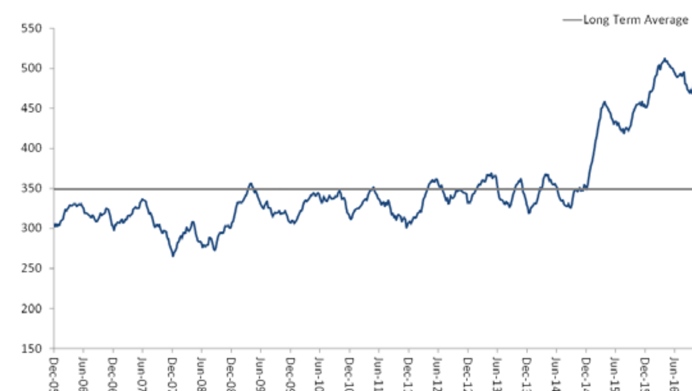
What are the team's initial reactions to the OPEC announcement on November 30?

SD: I've outlined the current EIA (U.S. Energy Information Administration) forecasts for 2017 in the table below, along with how the proposed deal should affect supply and ultimately feed through into the level of over or under supply in the market. If the deal is adhered to, and assuming demand and supply forecasts are unchanged then we should see a significant inventory draw. 45m b/d in Q1, 81.9m b/d in Q2 and 64.4m b/d in Q3.

In total that would be an inventory draw of 191.3m barrels over the first nine month of 2017. To put that in context, U.S. inventories which are perceived to be very high, and often used as a proxy for global oil inventories, are currently around 100m barrels above their long term average. So this is a big deal and could see a sizeable draw on inventories in 2017. With demand currently expected to grow in excess of supply in 2017, the market would move into a more structural level of under-supply in 2018 unless prices reached a level which triggered a sizeable supply response from U.S. shale.

	Current EIA Forecast	Proposed Supply Cut	After OPEC Deal
Q1	Oversupply 0.5m b/d	1m b/d (0.4m OPEC / 0.6m Non OPEC)	Undersupply 0.5m b/d
Q2	Oversupply 0.4m b/d	1.5m b/d (0.9m OPEC / 0.6m Non OPEC)	Undersupply 0.9m b/d
Q3	Undersupply 0.7m b/d	Unchanged	Undersupply 0.7m b/d

Department of Energy,
US Crude Oil Inventories (million barrels)



Source: Bloomberg

JR: Agreed. Equity prices have reacted accordingly, and continue to do so. I dare say Mr. Trump is happy with this outcome, along with those working in Houston. I suppose the key question becomes what oil price is required to trigger an extra 1m b/d elsewhere (meaning the U.S.)? How quickly can rigs, pipeline and off take capacity, pressure pumping equipment all get back to work?

Equities were already pricing in oil prices above strip, but I imagine that the sector will continue to perform well until we can see or determine where the cap is. Hard to see anything but the usual "Santa Claus rally" for the oil patch.

DF: In recent conversations I've had with industry executives, they pointed out that if OPEC was producing 34m b/d at around $45, they are actually better off producing 32.5m b/d at >$50 (assuming that price holds). Also, the result of the U.S. Presidential election was critical in forcing the Iranians to cooperate, given the potential threat of the U.S. undoing the sanctions relief.

How much commitment do you think there is among OPEC members to stick to the agreement?

JV: Although there is strong reflationary sentiment globally, I feel skeptical that non-OPEC will agree to cut anywhere near to 600,000 b/d from present levels (and U.S. production is already starting to rise), and even if they do, implementation is doubtful. OPEC implementation is doubtful too, in my opinion. Of course, there is a seasonal cut in production at this time of year, anyway.

JR: First, I think they are only considering a cut because OPEC is producing almost at capacity, and their market share policy has failed. They cannot act as the "oil police" and global shock absorber if they operate at full capacity. Also, it's in their interests to cut and raise fiscal revenues. So the cut makes OPEC and Saudi Arabia relevant again, at least for a while. I don't think that OPEC will cut unless Russia is complying with its agreed cuts though, so the risk of non-compliance is high.

It would seem more likely that OPEC and non-OPEC will not manage the full cut, and that they are unlikely to persist with the cut beyond the summer. To persist with the same level of output would probably mean significantly higher oil prices, and the risk of permanent market share loss to the U.S. and acceleration in 'peak demand'.

DF: According to a recent Goldman Sachs report, "Looking at the last 17 production cuts (1982-2009), observed production cuts have typically come in at 60% of the announced cuts, as measured by the change in secondary source production vs. the decline announced as calculated by the difference between pre-cut production levels and the announced quota levels." I agree with John on the likely cheating, and Russia/non-OPEC's willingness (or lack thereof) but it's hard for me to pinpoint how much of that will occur or how severe it will be. It does seem likely to me that it won't be Saudi Arabia cheating, and is more likely to be Iran, Iraq and Russia.

SD: On compliance I'd be much more optimistic. I don't believe that you can compare the current deal with historical scenarios. For the past 18 months we know that there has been significant discussion behind the scenes regarding deals and non-compliance, given various comments by Saudi and other OPEC officials. We also know that some OPEC members have this time given unprecedented levels of detail on production. There is now to be a new monitoring committee with Kuwait, Venezuela and Algeria representing OPEC and two non-OPEC members (probably Russia being one), and this committee will use secondary sources to monitor production and ensure compliance. If there is non-compliance the whole deal comes down.

Critically for me we have two of the largest cutters, Saudi Arabia and Russia, who I believe are probably running into problems after over producing for too long. Then the usual suspects such as Venezuela have been broken by low prices, they need this deal to work. Nigeria is exempt but they are facing new attacks and supply disruptions anyway.

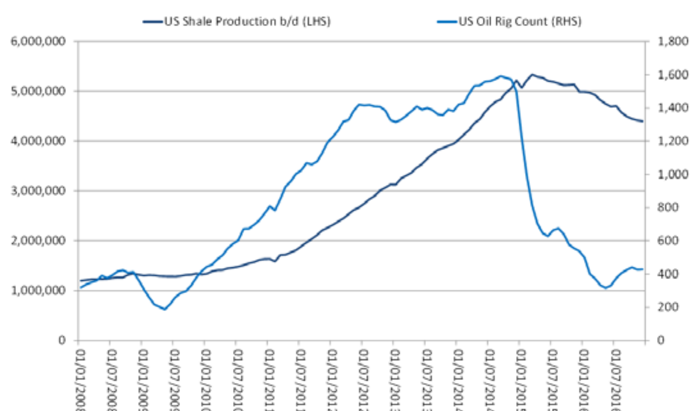
On non-OPEC production, it sounds like Russia have committed to 300,000 b/d, so half of the planned cut. Other countries that are part of the deal appear to be Azerbaijan (860,000 b/d estimated production), Kazakhstan (1.7m b/d), Oman (285,000 b/d) and Mexico (2.2m b/d). There is no way that this deal would have been struck unless there was a high degree of confidence that other parties are on board.

Does this mean that the U.S. assumes the role of swing producer going forward?

DF: The capability is there for the U.S. to double production, the question is what price is needed for some of the basins to work again from a profitability standpoint. If the U.S. now assumes the role of swing producer that means we need an additional 1m b/d of U.S. production next year, and we would need to see rig counts in the U.S. continue to rise by 10% or so from current levels to meet that type of need. Given the existing inventory of drilled but uncompleted wells (DUCs) in the U.S., increased completion activity could mitigate the need for additional rigs while also providing incremental supply.

In terms of profitability in the U.S. oil patch, higher prices would be very good, as most companies are saying they can retain 50+% of the cost reductions achieved over the past year, and that there isn't much pricing pressure from the oilfield services companies, even with the recent pickup in activity. Of course, the producers are also indicating they will spend any incremental free cash and continue to run cash neutral/slightly negative.

U.S. Shale Oil Production vs. U.S. Rig Count



Sources: EIA, Bloomberg

JR: We are all going to find out how responsive the U.S. system is, and where the natural cap is. Therefore the move in share prices appears rational, although as I've said before the equities already price in oil above strip. The earnings momentum will be difficult to resist.

If U.S. production grows into demand, there will be an annual inflow of $18bn or so into the U.S. each year (assuming a $50 oil price). The U.S. will take market share. A cap will be reached and then OPEC will try to get market share again. This cycle will continue until peak demand is reached or cheap shale is exhausted. I think it will be the former first. It is likely bullish for the US oil patch and the U.S. Dollar. It can't be good for emerging market consumers of oil.

I think it is right to focus on the timing and scale of a shale response; it will take a while for production to flatten off, never mind grow. The best case scenario (barring forced shortages, wars, etc.) is the full cut and a rebalance to normal inventory levels by the summer of 2017 or Q3 2017. The rise in the oil price will incentivize U.S. producers to put capital to work today. If OPEC keeps their cut into the second half of 2017, then yes, it will take some time for the U.S. to counter the market shortage, and we will move into below average inventory levels and prices will spike.

The other point I would make is the consistent underestimation of technological and industrial knowledge that has led to U.S. production levels exceeding expectations, despite capital spending reductions. It has been wrong to underestimate US production.

SD: On U.S. shale, the latest EIA data still has shale production declining as per the numbers below.

EIA U.S. Shale Oil Production

Date	US Shale Oil Production
Jan-2016	4,991,727
Feb-2016	4,974,569
Mar-2016	4,924,540
Apr-2016	4,825,170
May-2016	4,753,174
Jun-2016	4,693,809
Jul-2016	4,708,823
Aug-2016	4,578,695
Sep-2016	4,499,600
Oct-2016	4,449,943
Nov-2016	4,420,154
Dec-2016	4,402,685

Obviously that will change at higher prices, but even when U.S. shale production was ramping up at its peak, they were only adding around 100,000 b/d per month. Looking at just the Permian Basin, it was much less than that. So even in an optimistic scenario where U.S. shale production turns around very quickly, it could take some time to counter a market shortage. This also assumes that OPEC would be unwilling to add supply by rescinding the cuts if the market were in a deficit.

Conclusion

1. There is a fair amount of skepticism about the true impact of the announced cuts. This could result in the market remaining in surplus a little longer than the magnitude of the cuts may imply.
2. If OPEC members show discipline and the full amount of expected reductions is implemented, we are likely to see a supply deficit in 2017. The U.S. is capable of assuming the role of swing producer, but needs higher prices to ensure they can and will. The danger is that the U.S. producers lose discipline and increase production too much, and the market goes right back to where it started, with OPEC again stepping in to enforce supply discipline.
3. Higher oil prices likely support the outlook for higher inflation and perhaps higher interest rates, supporting a stronger USD. The recent oil price increase aggravates what already promised to be inflationary pressure in 1Q17, due to the base effect from low oil prices in 1Q16. If prices spike due to a supply deficit, this could cause inflationary pressure above consensus and may result in faster monetary policy tightening actions next year.
4. Oil prices should remain above $50 (Brent) for the next 6 months and the future path will be a function of the speed and magnitude of the U.S. supply response to any deficit in the market balance.
5. Industry profitability should continue to improve in 2017, as higher oil prices year-over-year, the expected retention of recent cost reductions, and further productivity improvements help boost the bottom line for many oil producers.

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