OPEC Extended Production Cuts: Why Prices Fell

• Last week’s price plunge was the third time in 2017 that prices have adjusted downward toward the $45 per barrel level suggested by market fundamentals.
• IEA calculated that recent production cuts earned the cartel an additional $75 million per day year-over-year in the first quarter of 2017.
• OPEC’s goal has been to keep a floor under current prices but the market expected the cartel to move prices higher through inventory reduction.
• OPEC was satisfied with greater revenues from higher prices compared to a year ago, but the market wanted deeper production cuts.
• OPEC takes the long view but the market is concerned with the near term.
• OPEC extended the cuts and the market reacted with lower prices.
OPEC’s Goal: Keep a Floor Under Oil Prices Without Helping Competition Too Much

- At first, OPEC did nothing after oil prices collapsed in 2014.
- When prices fell to $26 per barrel in early 2016, OPEC floated the idea of a production freeze and that established a floor from which prices increased to more than $50 per barrel during the first half of the year.
- In June 2016, markets lost faith in OPEC’s resolve and prices fell from $51 to below $40 per barrel.
- OPEC then set another price floor by announcing tentative agreement on a production cut.
- When prices fell below $43 in November, another price floor was created when OPEC enacted production cuts.
- The world price floor moved up almost 75% from $26 to $45 per barrel in just over a year.
- Production cuts were extended last week to reinforce the current $45 floor without helping the competition too much—not to meet market expectations of higher prices.
Oil traders understand this better than analysts and they began unwinding their long positions in February.

- Net long positions on WTI futures have fallen 25% since then but most of the sell-off has been since April 2017.
- Long positions commonly over-shoot price trends and prices fall after highest levels.
- Term structure of WTI futures contracts in fairly steep backwardation since mid-April.
- Prices less than $50/barrel until 2020.
Reasons for Lower Oil Prices

- Many analysts proclaim that Brent prices will be near $65 by the end of the year.
- Although IEA and EIA production data suggests good OPEC compliance with the November agreement.
- Iraq will have a hard time maintaining cuts with ISIS war and other fiscal pressures.
- Russia production currently in a seasonal low that increased 500 kb/d in 2H 2016.
Reasons for Lower Oil Prices

- Still, global markets remain well supplied.
- OPEC shipments to its biggest customers—the U.S. and China—are more than 10% higher than a year ago.
- Production cuts are not reflected in well-supplied markets nor are global inventories falling much.
Market concerns are valid that U.S. tight oil output may cancel OPEC production cuts.

Despite frack crew shortages and limits to pressure pumping equipment, 2017 well completion rates appear strong in the Bakken, Eagle Ford and Permian basin plays.

EIA forecast is for total crude oil production to increase 0.96 mmb/d in 2017, another 0.61 mmb/d in 2018 (1.57 mmb/d total 2017-2018 increase).

Most of the decrease in break-even prices is because of lower oil-field service costs and not efficiency and technology.
Supply, demand and inventory indicate $45/barrel “right” price for both Brent and WTI.

Current $52 Brent is ~$7 overvalued, $49 WTI is ~$4 over-valued.

Both OECD and U.S. inventories ~130 mmb above 5-year average.

At current rates of inventory withdrawal, it will take ~12 months to reduce stocks enough to support $65/barrel prices.
Comparative Inventory Indicates $45/Barrel Price for Brent and WTI

- World production surpluses have been falling for the last year but EIA expects these to start increasing as early as May.
- Surpluses may persist through the middle of 2018 before decreasing again.
- Its forecast is for Brent prices to remain less than $60 per barrel through the end of 2018.
- EIA forecast is for flat OECD inventories through 2017, then increase in 2018.
- U.S. inventories predicted to fall in 2018 then, increase in 2018.
- Macquarie Research
Macquarie Research Predicts Sub-$60 Brent Through 2Q 2019

Recent modeling by Macquarie Research supports this view and predicts sub-$60 Brent prices through the second quarter of 2019.

Although OPEC cuts appear to be real, Macquarie sees U.S., Russia and Brazil production growth as bearish drivers on price.

Maintaining OPEC cuts beyond the end of 2017 will be difficult.

Recent talk of selling half of U.S. strategic reserves potentially puts an additional 300 million barrels of oil on an already over-supplied market.

Term structure of future strip in backwardation with prices less than $51/barrel until August 2021.
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World liquids production will increase 4 million barrels per day by the end of 2018.

62% of increase from U.S., 28% from OPEC—capital markets & central banks key to capital availability.

That will mean relatively low oil prices, a requisite for the global economy to muddle forward.
Major Price Spike Sometime in the Next 5 Years

- Under-investment will ensure tighter supply in the future.
- Reserve replacement at a 70-year low.
- Despite good headlines about E&P break-even prices, ROCE is declining.
- Oil & gas company stock performance well below S&P 500 returns.
Oil Markets in Early Recovery From Oil Price Collapse

- Second major bubble since 1970.
- When oil prices got too high in 2008, the system crashed. Real estate and banking are the explanation but the cost of energy was a constant underlaying those factors.
- When oil prices got too high again from 2011-2014, there was no financial collapse but there was an oil-price collapse. It does not feel as cataclysmic as 2008 for those outside the oil industry because it made energy more affordable.
- Oil prices still 40% higher than during period of GDP growth in 1980s and 1990s.
- Average price of oil since 1950 in constant 2016 dollars was $46/barrel.

U.S. Debt and Tight Oil

- U.S. has been funding growth with debt since the early 1970s after U.S. oil production peaked.
- High interest rates in the early 1980s made the Treasury bond the reserve asset of the world and allowed the U.S. to put growth on a credit card.
- Low energy costs through late 1990s helped growth.
- Low interest rates and dollar devaluation after the Financial Collapse produced capital flow to tight oil plays.
- Now, tight oil is more than 50% of U.S. oil output and increasing.
- Bakken and Eagle Ford plays are probably in slow terminal decline.
- This means that the Permian basin is the sole growth area.
- Further reason for a price spike in the coming 5 years.