June OPEC Meeting: the Start of Another Oil Price Decrease?

By Alexandre Andlaurer*

Oil Prices Increase: Speculation?

After a strong rebound in oil prices in the first months of 2015, questions are now being raised on the nature of the increase and its sustainability. Here are some potential explanations:

- First, it looks like that the sharp decrease in the number of rigs in the U.S. came as an (misleading) indicator forecasting lower production. Rig counts plunged by approximately 60% and U.S. production levelled off for the first time since the shale boom began.
- Second, the lower oil price environment has raised the consumption of oil products around the world.
- Third, the cut in investments by all oil companies is a sign that production will decrease.

These arguments are reasonable but what is really behind them?

The Increase in Supply is Everywhere (despite the cut in capex)

More than $100bn of spending by the world's energy companies has been slowed, postponed or cancelled. As an example, one of the biggest developments to be shelved is Shell's Arrow liquefied natural gas plant in Australia, accounting for almost a quarter of the planned spending reduction. On the other side of the world, some Canadian oil sands projects have been cancelled with a cut close to $10bn.

What does this mean? From the natural gas point of view, and LNG, it is clear that production would be lower, as prices are doubly put under pressure: U.S. natural gas support prices (and future exports + coal transmission belt) and oil prices plunge with the link to European and Asian natural gas prices. From an oil production point of view, it looks like that the cut in investment will not hit production for the next five years. And especially not in the next three years. The results from the integrated oil companies in Q1 2015 showed, conversely, some impressive oil (liquids) production growth. ENI alone increased production by 5% vs. Q1 14, while Total and Royal Dutch Shell increased respectively by 15% and 1% compared to the previous quarter, Q4 14.

When asking 25 CEOs from oil & gas companies around the world, an expert reported that the answer was the same. None has cut oil production for the next five years. So where should the lower production come from? OPEC countries, Russia, Brazil, Canada?

This seems not be the case.

- In Canada, where the Canadian oil sands are said to be unprofitable (which is true), production reached an all time high at 4mbpd. Suncor, Canada's largest integrated oil and gas firm, said oil sands production rose to a record 0.44mbpd compared to 0.39mbpd a year earlier. No slowdown is expected in the next three years.
- In Russia, oil and gas condensate production, among the world's largest, remained at a post-Soviet record level of 10.7mbpd in April. The lower investment and ban on technology will not affect production before 2019.
- Despite Petrobras' problems with corruption, and challenging extraction, the company posted a new oil production high of 0.8mbpd in April (and this is true for all its partners) from its offshore subsalt region, the state-run oil company said on Tuesday (19/05/2015). Petrobras is producing 80% of Brazil's oil and gas from the subsalt polygon, an area where large oil reserves are trapped by a layer of mineral salts far beneath the seabed.
- On the OPEC side, Saudi Arabia's crude exports rose in March to their highest in almost a decade, with 7.9mbpd shipped, up from 7.35mbpd in February, the highest level since November 2005. The Oil Minister Ali al-Naimi said Saudi Arabia produced some 10.3mbpd of crude in March. This eclipsed its previous recent peak of 10.2mbpd in August 2013, according to records going back to the early 1980s. In Libya, production is still a third (436kbpd) of the pre-war level. Mr Sanallah, the chairman of the national company said that Libya and Iraq would also be focusing more on recapturing market share, regardless of OPEC quotas. That is true. And there is only upside in the next two years. Finally, Iran could also add 0.5mbpd in 6 months, but we are more conservative on this one as this seems more like a long-term discussion.

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At a glance, the disruption is still close to a 10-year record for the Middle Eastern countries, but everybody is looking to increase their production and get market shares.

- Finally, in the U.S., the number of rigs has become an obsolete indicator in tracking production. There is obviously a lag between the fall in the number of rigs and production, as there is a link with hedges from shale oil companies, but rig counts have become a misleading indicator. Flying to quality (less wells, but much more productive), horizontal drilling, technology improvements and efficiencies are elements that are not well represented by the number of rig counts. Also, the new trend of uncompleted wells upsets the expectation on production, but let us show what the impact could be. The number of uncompleted wells in the U.S. (which must be fracked or abandoned) is 2,500. Based on a 400kbpd IP, production should be 1mbpd. 60% of costs have been spent on these uncompleted wells, so completion seems inevitable. Some of the production is offset by the high declining rate. But it is still high enough to keep production rising by another 300kbpd without new rigs in the U.S. for 2015. Let's take as an example North Dakota. At the end of March, there were an estimated 880 wells awaiting a completion service. To maintain production near 1.2mbpd, 110 to 120 completions must be made per month, according to the DMR. Seven months remain, or 840 wells, to be completed to stabilise production. 40 remain to increase production with no more rigs. But there are still 80 active rigs. In other words: even without new rigs, production can rise in the U.S. in 2015.

All in all, supply should be up by 0.8mbpd in 2015 from non-OPEC countries. April marked the 12th consecutive month in which OPEC production ran above the groups' self-imposed 30mbpd target.

Demand is Revised up on Lower Oil Prices

Consensus figures see demand as high as +1.3mbpd for 2015 vs. 2014. Oil demand continues to surprise on the upside. And the U.S. looks to be the main swing consumer. Low taxes, the biggest consumer in the world, and the start of the driving season are the key explanations for this. Demand from refineries is the strongest at this time (driving season) of year when production should rise by more than 5% yoy according to the American Automobile Association. The latter said road travel was expected to reach a 10-year high. In other words, consumption in the U.S. should grow by 400kbpd in 2015, thanks to lower oil prices. In Europe, Vitol recently said it expect consumption to increase by 0.5mbpd.

Also, demand should be analysed in India and China, the key growth drivers of the last five years. Sensitivity to lower oil prices at the pump is low, as the trend is more driven by new cars than by people willing to drive more with low oil prices. In China, crude imports hit a record 7.4mbpd in April, with healthy car sales. The increase has also been driven thanks to the start-up of 39mb of commercial storage. Nevertheless, China's fuel demand will grow by 3.1%, according to the EIA. This compares with an 11% jump in 2010. Annual growth has averaged 5.2% in the past ten years

For sure, the rebound in consumption is here, and it is visible. But this short-term higher oil demand driven by lower oil prices (at least in the first months of 2015) is unlikely to offset the structural long term trend as the world's economy is experiencing transformational changes: gains in industrial productivity, efficiency of new cars, rapid urbanisation, bets on renewables etc.

OPEC Meeting, a Non-event, Shale Oil Producers Still the Swing Producers

Supply is increasing everywhere, as demand is too. What could change in the second part of the year is the size of that increase of supply and demand. On one hand, no further upward revision in oil demand (maybe downward). On the other, greater production from shale oil players. The dynamics in H2 would be on the supply side. The reason? Oil prices are at a level where the producers are happy and back to business, however, the positive impact from lower oil prices is also true but usually only in the first six months, abd then comes to an end.

During the first quarter results, shale oil companies clearly highlighted their ambitions, first to bring rig numbers back as oil prices are at $65/bbl: in mid-May the number of rigs drilling for oil totalled 659, just one less than the week before (the end of the trend?). Also, companies mentioned they will complete wells in the coming months (Q3) as already 60% of costs has been spent. The completion of the wells is an indicator to follow, as mentioned earlier: The reduction in completions happens four months after the rig count reduction according to people involved in completion. A starting point right now.

Last, but not least, shale oil producers have already decreased costs by 15% in three months, with a potential of 25% for the full year. The $65/bbl (on WTI) is heading towards $50/bbl in the next two years. Support for funding of these companies has found generous private equity investment over the last few months: a lot of cash has been invested. Blackstone has set $9bn aside for energy investment. EnCap

and Warburg Pincus are sizing up the market, armed with $5bn and $4bn, respectively.

So what could be the price for oil?

With its ability to bring production to a couple of millions of barrels in 20 days, shale oil producers are the new swing producers. What does this mean for oil prices? Probably more volatility in a low range with a stop and start system from this type of producer accounting for 6% of the world's production in 2015. So before shale oil production is disrupted, the oil price should reach $50/bbl, and stay there for a while. What happens afterwards could be this scenario: a $50-$70/bbl range, and the story repeated until other countries change the strategy, nothing expected for 2015, or even before 2018.

And what about the OPEC Meeting?

There is a general consensus that oil prices will recover amongst OPEC countries. And that they have been successful in their strategy to lower production in a high break-even area (which is true when taking rig counts as an indicator) with a visible impact at some time towards the end of 2015. Under this condition, and regarding the production increase from OPEC countries to support the health of their population, it is hard to believe that the OPEC Meeting on 5th June will decide on a cut in production.

The timing of this OPEC Meeting corresponds with the start of the U.S. driving season (a pick-up in demand may not continue to support prices down the road) and this is a perfect cocktail to start a decrease in oil prices. Unless demand accelerates, the rally is in danger.

Obviously, there could always be a geopolitical development that may completely change the picture. The market is very sensitive to relative excess supply; it can go away in a blink, say, if OPEC changes its policy. But fundamentals, notably in the U.S., have not changed much, oil prices could reach again the $50/bbl in H2 2015.

Over 2020, oil prices could again trend upward, as Russia's problems and the Middle Eastern lack of investment could start to impact production, which would not at that time be supported by higher shale oil production (which has a limit of 8mbpd vs. 4.4mbpd today).

Lars Bergman, Past President of the IAEE, was awarded H.M.The King's Medal of the 12th dimension with the ribbon of the order of the Seraphime for his valuable contributions to Swedish society. The ceremony took place on the 16th of June, 2015 at The Royal Castle of Stockholm.

There are seven levels of the Royal medal, with the 12th level or dimension being the highest. The ribbon of the Seraphime order is the second highest from the top.

Congratulations, Lars!!