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MACROCOSM

Market Share for Cannibals

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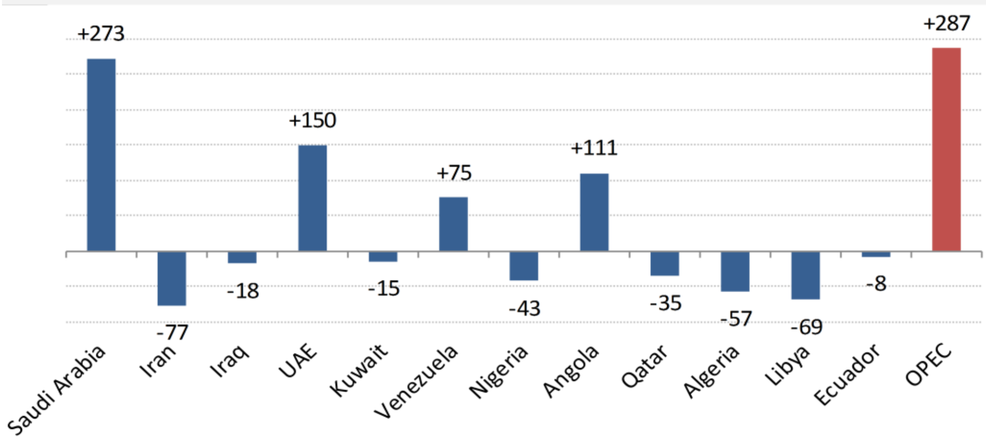
Michael Warren

Saudi and UAE are the only OPEC winners. As shale rolls over, the cartel's share will grow.

On Friday OPEC announced it would maintain its crude oil production targets -- continuing last November's historic strategic shift to let markets set prices, in the hopes that a regime of lower prices will allow the cartel to increase its global market share. Last week's meeting in Vienna can't have been pleasant for cartel members -- especially having to listen to ConocoPhillips chair Ryan Lance lecturing that "shale is here to stay," and doing a victory lap on his 2012 warning to OPEC that it was underestimating shale's potential.

So far, the market share changes have been mostly within OPEC itself. As we expected, Saudi Arabia has been a winner (see "Saudisfaction Guaranteed" March 13, 2015), increasing its production by more than a quarter million barrels/day, at an annual rate, compared to its 2014 average (please see the chart below). The United Arab Emirates increased production by roughly 150,000 barrels/day. All other OPEC members, except Angola (which is increasing heavy oil production) and Venezuela (if you believe their numbers) have seen a decline in production. Overall, OPEC production has grown by just 14,000 barrels/day.

Change in production, 2014 average versus 2015 to April Bbl/day, annual rate



Source: OPEC Monthly Oil Market Report, TrendMacro calculations

While the Saudi's have benefitted from OPEC's market-based pricing strategy by grabbing a bigger piece of the cartel's pie, the cartel as a whole will start to gain in 2016 (please see the chart on the following page).

Update to strategic view

OIL: OPEC stands by its production targets, continuing to let the market set prices, hoping to earn greater market share. So far Saudi Arabia has, but at the expense of other OPEC members. The cartel overall should see increased global share by next year. US shale production has rolled over, as we expected. At the same time, Middle East instability offers both upside and downside risks to production (mostly downside). Decelerating US production takes a destructive oil fire-sale off the table, but the ability to ramp up production "just in time" also rules out an upside blow-out. We stand by our 2015 price target -- a range of $50 to $65.

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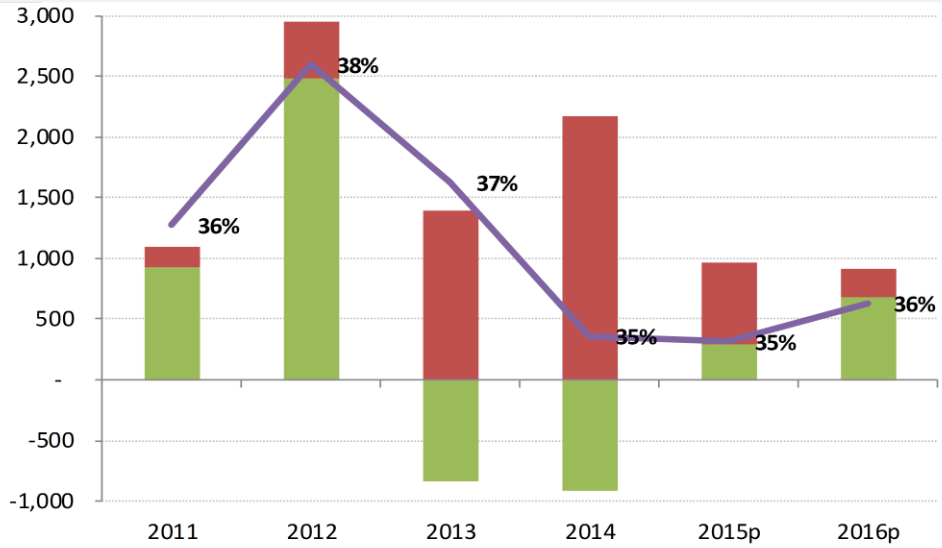
Change in average annual oil production Thousands bbl/day

OPEC Non-OPEC Market share



Source: OPEC Monthly Oil Market Report, TrendMacro calculations

The wide fluctuations in OPEC market share over the last five years can be attributed to three member nations. Sanctions reduced Iranian output; Libya's civil war radically impacts production on a year-by-year basis; and Iraq has been slowing building up productive capacity. While all three countries provide upside production potential, there remains an important downside risk: geopolitics.

- Because it is so salient to US political dynamics, media commentary tends to obsess about incursions by ISIS into Syria and Iraq. We've long pointed to that risk (see "The Stench of CrISIS" June 25, 2014). Late last month ISIS set ablaze the Baiji oil refinery more than 100 miles north of Baghdad, in the process of pulling out of the area they had held since June of last year. Respectful that there are unknown unknowns in play, our overall take is that, ironically, ISIS is a force for regional unification -- equally threatening all established interests, and driving closer cooperation with the US.
- We are more focused on the Shia/Sunni cold war turning hot in Yemen, pitting superpowers Saudi Arabia and Iran in what could blossom into a full-blown regional conflict that could spill over onto innocent bystanders. As we expected could happen (see "Oil and the Obama Doctrine" April 10, 2015), Iranian gunboats have fired on a Singapore tanker in the critical Straits of Hormuz, and yesterday the Saudis reportedly shot down a scud missile fired into their territory from Yemen.
- To be sure, the flip side of these risks is that they don't materialize -- resulting in greater than expected OPEC supply.
- Some news reports have claimed that Iraq is ready to flood the market with an additional 800,000 barrels/day of crude, to help OPEC squash North American producers.

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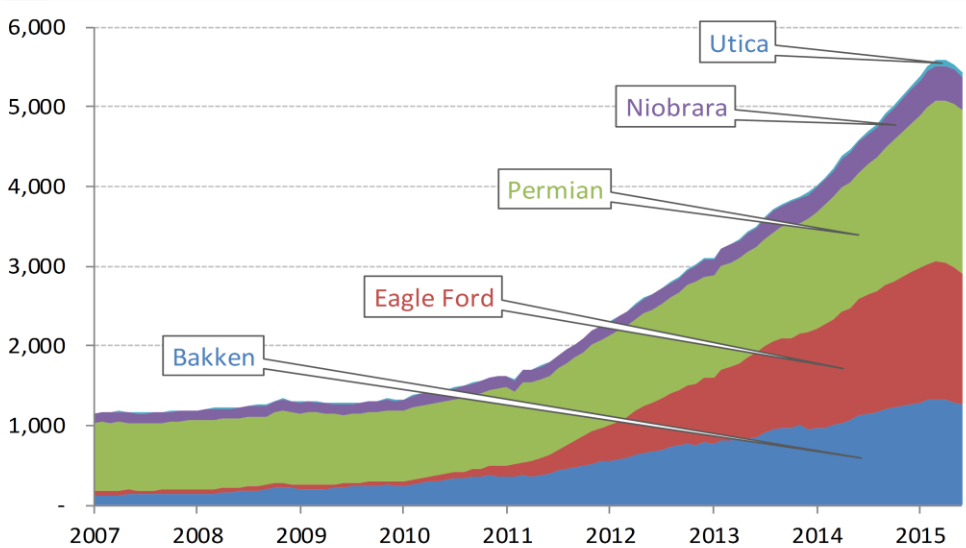
- Really? How is Iraq going to suddenly increase production by 800,000 barrels/day when it took the last five years to increase production by 750,000 barrels? And average production in the first four months of 2015 has been less than the average for 2014.
- In reality, Iraq is signing up oil transport vessels to replace the lost exports from the destruction of the Kirkuk-Ceyhan pipeline by ISIS earlier this year (again, see "Saudisfaction Guaranteed"), and redirecting barrels that used to provide the 310,000 barrels/day Baiji refinery with feedstock. The Baiji refinery supplied Iraq with the majority of its fuel, so Iraq will need to *export oil* and *import gasoline and diesel* to continue to meet existing domestic demand.
- Another upside risk is Libya increasing production and exports. But the latest developments point more to a possible slowdown in production, due to protests at the eastern port of Zueitina. Libyan 2015 production will likely be about what it was in 2014 -- and if there is a shortfall, the Saudis will fill it. At this time it appears that Libya is years away from regaining the 1.5 million barrels/day production plateau that it had prior to the overthrow of the Gaddafi regime.
- Finally, the biggest upside supply wildcard is the Iranian nuclear deal. Our opinion remains that the deal doesn't make much sense and is highly likely to fall apart -- but that doesn't seem to matter to the Obama administration (again, see "Oil and the Obama Doctrine"). With final talks starting in earnest this month, if there is a deal, the Iranians could add another 200,000 barrels/day (on an annual basis) to 2015 production, and much more in 2016.

Meanwhile, the Saudi strategy to let markets set prices has impacted US CAPEX, rig counts and production. US oil and condensate production from major light tight oil and shale formations has rolled over, as we projected in April (please see the chart below, and again, see "Saudisfaction Guaranteed"). Bakken production rolled over in March, and Eagle Ford

Oil and condensate production Thousands barrels/day



Source: DOE Drilling Productivity Report, TrendMacro calculations production in April. While Permian Basin production is still inching higher, its modest increase can't reverse the declines in the other major plays.

- The rollover in US production from light tight oil plays means that the nutty downside predictions heard earlier this year (see "Grant Me $20 Oil, But Not Yet" February 17, 2015) will surely not materialize. This spares the global economy a credit shock that would trigger history's first recession caused by falling oil prices (see "Houston, You're the Problem" March 9, 2015).
- On the other hand, if the geopolitical risks we have pointed to constrained global supply, the US producers have vast latent capacity to increase production "just in time" (see "The Shale Boom Shifts Into Higher Gear" June 1, 2015) -- production that will be extremely profitable even at only modestly higher prices (see "I Have Seen the Future, and It Fracks" February 24, 2015).

The combination of all these factors points back to our baseline forecast for 2015 that global crude benchmarks will trade in a range from $50 to $65, allowing for some speculative overshoot on both sides such as we have already seen (see "Oilmageddon: The Sequel" January 15, 2015).

Bottom line

OPEC stands by its production targets, continuing to let the market set prices, hoping to earn greater market share. So far Saudi Arabia has, but at the expense of other OPEC members. The cartel overall should see increased global share by next year. US shale production has rolled over, as we expected. At the same time, Middle East instability offers both upside and downside risks to production (mostly downside). Decelerating US production takes a destructive oil fire-sale off the table, but the ability to ramp up production "just in time" also rules out an upside blow-out. We stand by our 2015 price target -- a range of $50 to $65.