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On OPEC's Production Target

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Michael Warren and **Donald Luskin**

Freezing production that was frozen anyway makes the US fracker the swing producer.

As we predicted three weeks ago, OPEC's ministerial side-meeting at the International Energy Forum in Algiers has yielded an agreement in principle to discipline two years of members' bruising battle for market-share (see "OPEC Will Lose Its Battle of Algiers" September 9, 2016). According to a statement issued yesterday after the side-meeting, the idea is "to accelerate the ongoing drawdown of the stock overhang and bring the rebalancing forward." How different from OPEC's announcement in November 2014 that it would not curb production in the face of collapsing prices, with the Saudi oil minister saying "it is not in the interest of OPEC producers to cut their production, whatever the price is."

- According to yesterday's statement, there will be "an OPEC-14 production target ranging between 32.5 and 33.0 mb/d."
- This is being played in the media as a "cut." And it is, at least from August's 33.2 million barrels per day production. But July and August production are always seasonally high. The target is virtually a standstill from Q1's 32.5 million and Q2's 32.8 million.
- *So it's a "freeze," not a "cut."*
- As such, it really doesn't matter, any more than OPEC's *failure* to reach a freeze agreement in April mattered (see "On the Doha Oil Freeze Failure" April 17, 2016). The new target masks a situation in which OPEC spare capacity is extremely limited anyway. It's not clear to us that OPEC could anytime soon produce much above its new target, even if it wanted to (see "Who Knew? OPEC Actually Matters Again" June 6, 2016).
- *And it's by no means a done deal.*
- Details as to "the implementation of the production level of the Member Countries" and "a framework of high-level consultations between OPEC and non-OPEC oil-producing countries" will be "considered" at OPEC's next conference at the end of November, in Vienna.
- Maybe part of the rationale for the agreement is for core OPEC members Saudi Arabia, Iran and Iraq to hedge their bets, to bolster prices against the chance that troubled members Libya, Nigeria and Venezuela might restore production and quickly add volumes to a perceived glut in the market.

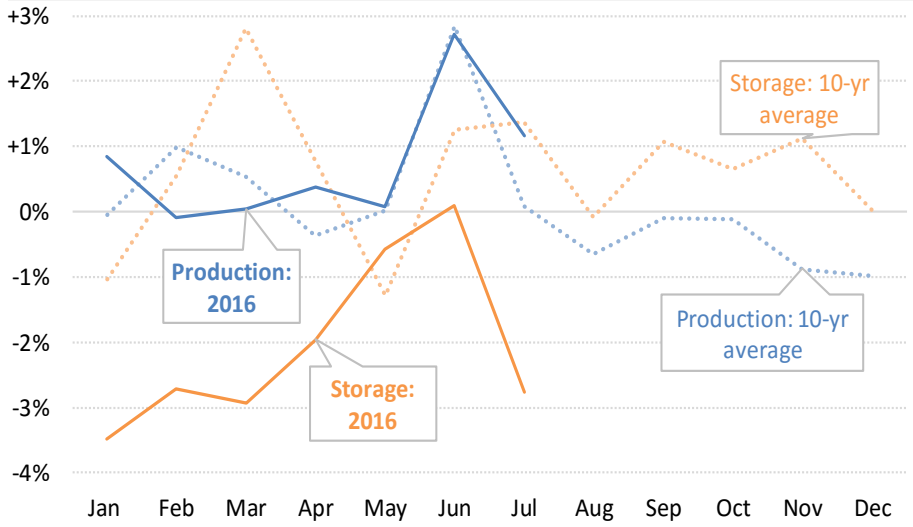
Update to strategic view

OIL: OPEC has announced a production target that amounts to a freeze at current levels, and will take until November to be detailed and agreed by members. This is mostly a face-saving exercise, to mask the fact that OPEC spare capacity is quite low – so production is effectively frozen with or without the target. That means prices will go higher in any event, with global demand likely to far outstrip supply a year out, and storage now getting back in line with historical norms. OPEC wants this agreement to hide the fact that the US fracker is now the global swing producer. Shale production is ramping up now in the Permian, where wellhead and transport costs are globally competitive at today's prices. As prices rise, other plays will ramp up despite higher transport costs, the sad result of the failure to approve and build new infrastructure. We stand by our call for $65 oil by year-end.

[Strategy dashboard]

- But we think it's mostly a face-saving exercise, a glorified form of bowing to the inevitable, just as the 2014 decision to not try to support prices bowed to the inevitable – that a disruptive new technology, fracking, had brought a powerful new competitor into the market.
- Now, OPEC doesn't want to lose the prestige and the power of being seen as the world's swing producer. Or to put it another way, it doesn't want to bear the shame that, after a brutal two-year war for market-share, the world's swing producer is now the US fracker.
- Even in the Department of Energy's perpetually optimistic assessment, spare capacity in OPEC is now only 1.25 million barrels/day. But a closer look makes us think it may well be less than that.
- Consider that Saudi Arabia's 2016 *production* pattern has followed its historical trend – so on the surface, no worries there. But its 2016 *storage* pattern has been almost all draws, month after month (please see chart below). At this point, Saudi storage is back down to the levels of 2014, before two massive new refineries – which ought to command higher levels of storage in order to be properly served – were brought online.

Saudi Arabia crude production and storage Monthly change



Source: JODI, TrendMacro calculations

- A Q1 Saudi storage drawdown prior to spring refinery maintenance season would normally signal to the markets, all else equal, that oil prices should rise – but they didn't. That's because, as we have previously pointed out (see "Oil's Brexit Crisis" July 26, 2016), Saudi aggressively forward-deployed supplies to key OECD demand centers to capture global market-share.
- We can see this close to home by subtracting import flows from changes in US stockpiles this year (please see the chart on the following page). When we do this exercise, we see that US stocks have actually had a very normal year – quite contrary to the constant harping by Wall Street that their apparently high levels signal continued glut.

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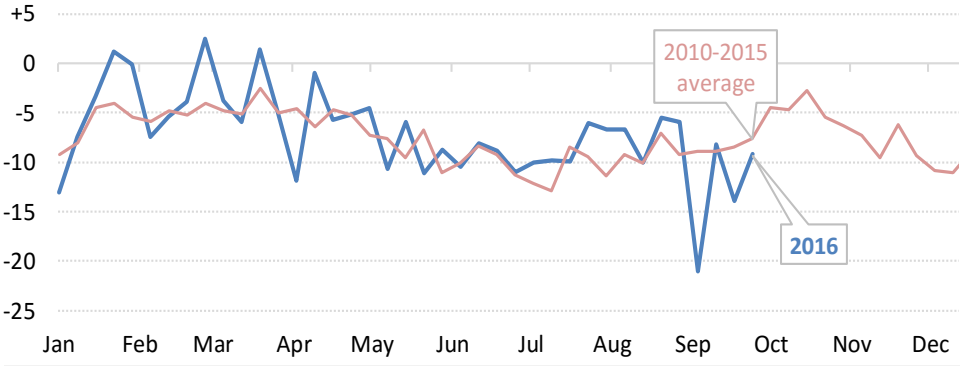
Recommended Reading

Testing Piketty's Hypothesis on the Drivers of Income Inequality: Evidence from Panel VARs with Heterogeneous Dynamics
Carlos Góes
IMF Working Paper
August 2016

[Reading home]

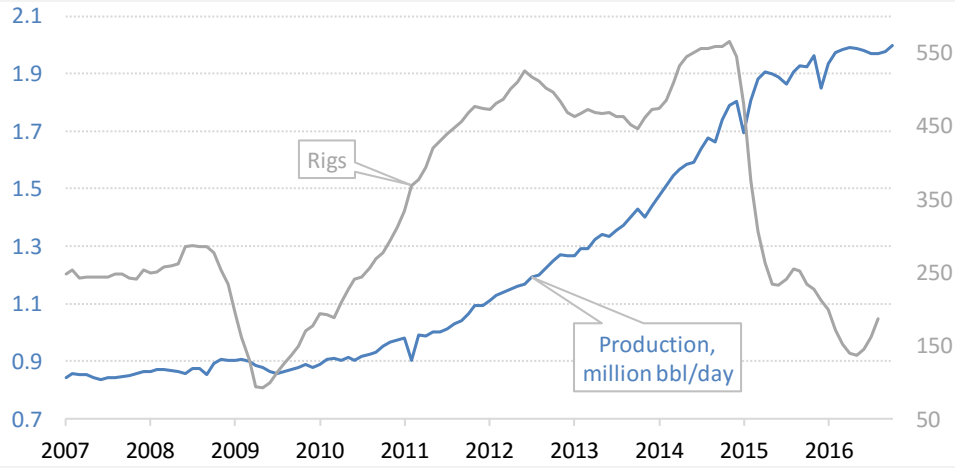
Weekly change, US ending stocks – imports + exports Millions barrels



Source: DOE, TrendMacro calculations

- As OECD storage levels clear – as they are now quite aggressively in the US – there will not be much of a cushion of stored Saudi oil, either for export of the Kingdom's use in its own refineries.
- *This is why oil prices have been rising since the February 11 bottom at WTI $26 – not because of some on-again off-again talk about a freeze or a cut.*
- *And whatever illusions OPEC may be able to sustain for a while, the US fracker is now the global swing producer.*
- While OPEC is talking about freezing production, the US fracker is beginning to recognize a looming global shortage, in which demand could exceed supply by 1 million barrels/day a year from now (see, first, "Who Knew? OPEC Actually Matters Again" June 6, 2016).
- Now is the time for the US fracker to fulfill the promise of shale as "just-in-time energy" (see "Just-In-Time Energy" April 27, 2015). Already, frackers are adding rigs in the most competitive and infrastructure-connected North American shale play – the Permian Basin.
- The Permian was the last US shale play to roll over (indeed, it barely did), and now it's become *the first to turn around* (please see "Data Insights: Oil" September 12, 2016, and the chart below).

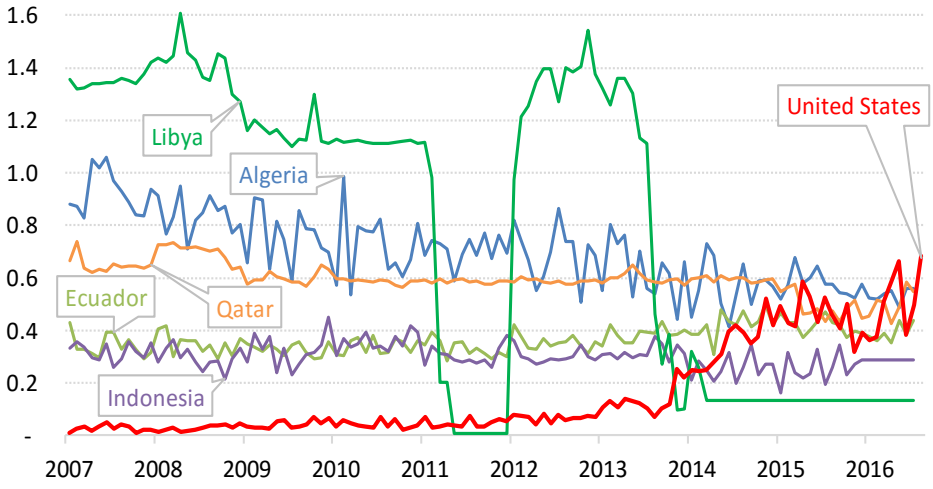
Permian Basin



Source: DOE EIA, TrendMacro calculations

- *This is the kind dynamism that will bring supply into play before the looming shortage becomes acute and leads to lines at gas stations. It will take higher prices to make it happen – we stand by our call for $65 oil by year end. But it will happen, supply will come into play, which is why we are not calling for $100 oil.*
- The revival will start in the Permian Basin, where wellhead costs are globally competitive, and where most oil can be transported by pipeline to the Gulf Coast refinery complex and crude export terminals. The cost of moving Permian light crude by pipeline is less than $3/barrel, making it competitive with global seaborne crude that has VLCC transport costs of $3 to $5 per barrel.
- Wellhead costs aren't much higher in the Bakken, but that play is disadvantaged because a third of its crude output is still being railed to the east and west coasts. Shipping crude by rail from midcontinent to East Coast refiners costs $12 to $15 per barrel – lowering net-back prices for Bakken operators by about $10 per barrel relative Permian producers.
- The shale revolution was made possible by the umbrella of high oil prices. They allowed costly and risky experimentation with novel technologies, and swallowed up high transport costs. But the crash in oil prices folded up that umbrella. Suddenly, for some operators, if their wellhead costs didn't kill them, then their transport costs did.
- Now, as prices recover, added infrastructure would help the US enthrone itself as the global swing producer faster, and do so at a lower global oil price. A slower recovery – and higher prices required to achieve it – are the true cost of the failure to approve and build the Keystone X-L pipeline (see "Keystone is Key to Low Oil Prices" February 2, 2015).
- The Obama administration has now killed another pipeline out of the Bakken, which further limits its global competitiveness in the global energy market.
- A perverse consequence of the lack of transport infrastructure is the boomlet in US crude exports, since the decades-old export ban

Crude oil exports Millions barrels/day



Source: JODI, DOE, TrendMacro calculations

was lifted – as we predicted it would – following the Iran nuclear deal (see "Iran: The New New World Oil Order, Volume I" July 20, 2015). The US now exports more crude than five OPEC members (please see the chart on the previous page). Why? Because transport costs are lower when shipping oil abroad (from Texas) than railing crude across country (from the Bakken to the coasts).

Bottom line

OPEC has announced a production target that amounts to a freeze at current levels, and will take until November to be detailed and agreed by members. This is mostly a face-saving exercise, to mask the fact that OPEC spare capacity is quite low – so production is effectively frozen with or without the target. That means prices will go higher in any event, with global demand likely to far outstrip supply a year out, and storage now getting back in line with historical norms. OPEC wants this agreement to hide the fact that the US fracker is now the global swing producer. Shale production is ramping up now in the Permian, where wellhead and transport costs are globally competitive at today's prices. As prices rise, other plays will ramp up despite higher transport costs, the sad result of the failure to approve and build new infrastructure. We stand by our call for $65 oil by year-end.