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MACROCOSM

Saudisfaction Guaranteed

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The Saudi strategy is working: market-based pricing will bolster its flagging market share.

In the face of massive and sudden increases in North American crude production, Saudi Arabia has experimented with moving OPEC's strategic model from price management to market-share management as the only way to maintain influence overall global energy markets. This means letting the market, not the cartel, set the price -- a lower price -- at which Saudi, with its unique advantages of vast low-cost reserves and political stability -- can come out on top. We think Saudi should feel that the experiment is working -- for itself, at least, if not for OPEC overall. So even as global crude benchmarks dip into the $50's, and US WTI into the $40s, we don't expect any reaction at all from OPEC.

The Saudis devised this strategy to push oil prices low enough to take some US production off the table going forward. With highly publicized cuts in CAPEX and reductions in rig counts, it will happen. We think Bakken and Eagle Ford production will start to rollover in April. In the meantime, the combination of momentum from last year's production boom and a scramble for productivity has North American operators adding commercial ending stocks at an unprecedented level. There is plenty of storage capacity to handle this production until refinery demand starts to rebound in April.

- We are nudging higher our 2015 US production forecast to 9.15 million barrels/day of crude oil and condensate production from our previous forecast of 9.0 million barrels per day (see "Oilmageddon: The Sequel" January 15, 2015). Our revision involves a higher than expected starting point for fourth quarter production, and the increased number of wells being drilled on pads. The Energy Information Administration has also revised its forecast higher by 50,000 barrels per day to 9.35 million.
- We're also moving up our estimate of 2016 US incremental production by 40,000 to 9.34 million barrels/day. EIA has reduced its forecast by 300,000 barrel per day to 9.49 million.
- *We stand by our call for crude to trade globally in a range from $50 to $65 in 2015. But for now there is obvious short-term downward pressure on the US benchmark. So the spread between Brent and WTI has been pushed out from zero during last year's oil price free-fall back to roughly $10/barrel.*

Update to strategic view

OIL: The Saudi strategy to let the market determine oil prices, and increase its own market-share, is working. So we don't expect a sudden change in policy to support prices. If production is curtailed in OPEC's several political danger-zones, the cartel has spare capacity to make it up. We are slightly raising our US production estimates for 2015, based on greater than expected momentum coming out of 2014, and a scramble for productivity. Oil prices for 2015 should remain in the $50 to $65 range, with WTI still seeing a short-term discount until refinery demand picks up after April.

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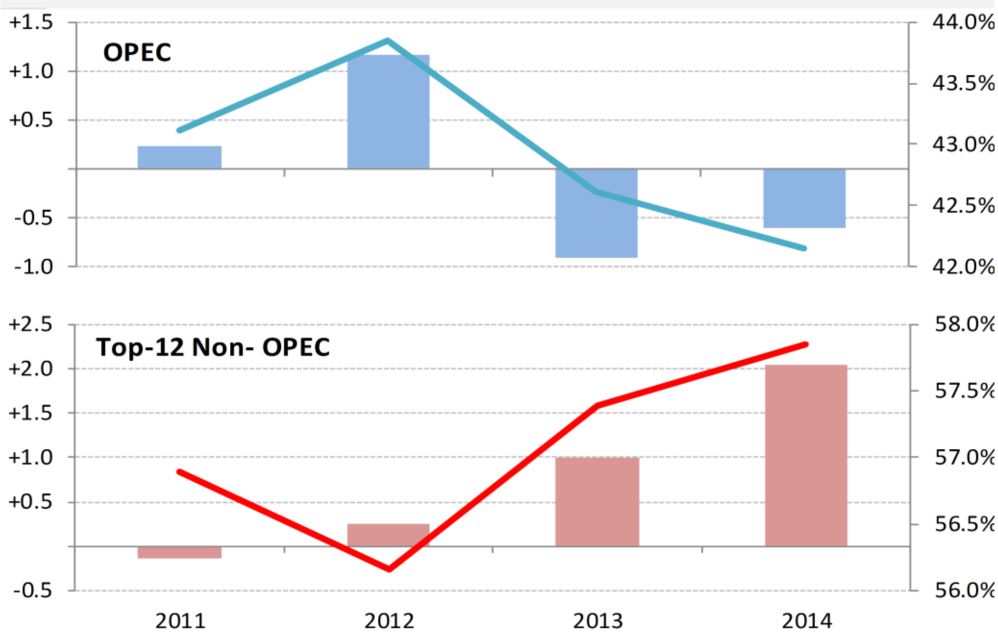
If it seems difficult to understand how the Saudis could see this as a victory, let's look at the strategic environment that they have faced, and understand how they've chosen to respond to it.

- In the first half of 2013, the Saudis were facing the new reality of a rapid increase in North American production -- the result of which was a drop in Saudi global market-share. Their strategy emerged in successive meetings held in Riyadh at the International Energy Forum (IEF), in Paris at the International Energy Agency (IEA), and Vienna at OPEC, from January to June.
- Saudi had to accept the evident reality that North America could continue to ramp up shale and light tight oil production at current high prices. So the discussion turned to estimating the marginal cost of production from the premier plays -- Bakken, Eagle Ford, and the Permian Basin. That's where theory would predict oil prices would fall, at a given level of demand, if OPEC got out of the way.
- Based on historical precedent, Saudi may well have been expected to cut back production. At the Riyadh meeting they were concerned that Libyan production, which had rebounded after hostilities abated with the overthrow of Gaddafi in October 2011, would continue to grow. How would the market accommodate resurgent Libyan production with North American light tight crude already displacing imports from other African OPEC members?
- But 2013 was offering OPEC a very troubling view of the world, one requiring different kinds of responses. The top-12 non-OPEC producing countries, led by the US and Canada, had captured the majority of incremental demand. As it turned out, they would continue to do so in 2014 (please see the charts below).

■ Crude oil and condensate production YOY Million bbl/day **— Market share**



Source: EIA, JODI, TrendMacro calculations

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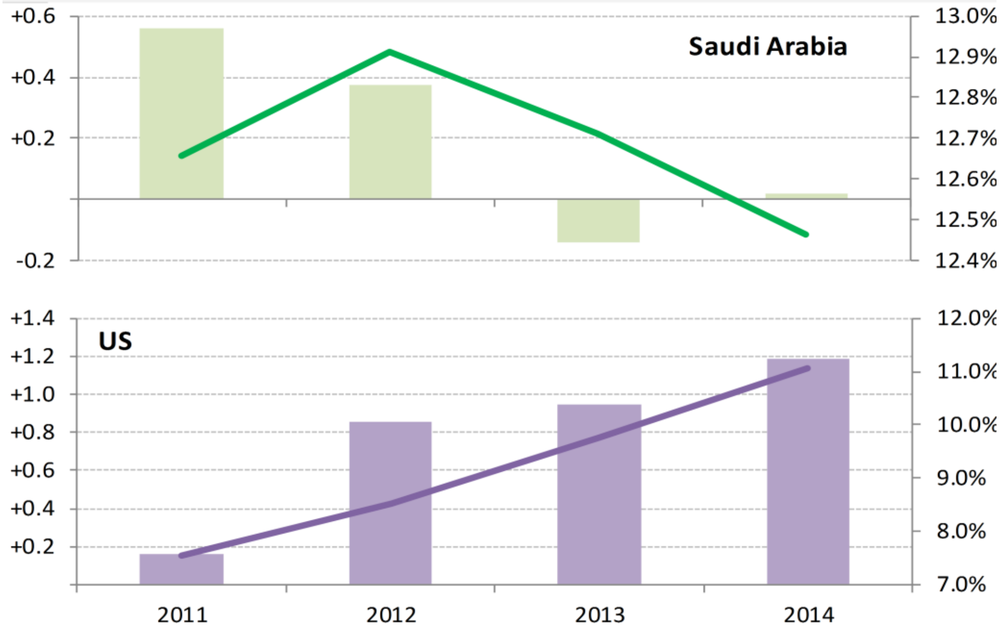
- *Most important, 2013 was the first year since the Great Recession that Saudi Arabia itself lost production and market share. Meanwhile, the United States displaced nearly 1 million barrels/day of crude from the market, and even more in 2014* (please see the charts below).

■ **Crude oil and condensate production YOY** Million bbl/day ▬ **Market share**



Source: EIA, JODI, TrendMacro calculations

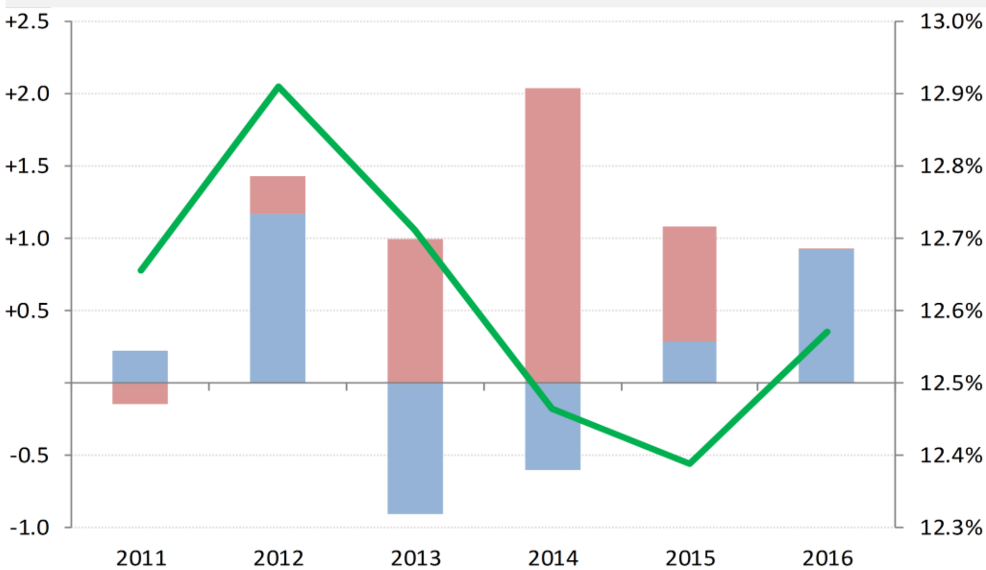
- So the stage was set for the November 2014 OPEC meeting in Vienna, where the Saudis proposed their great strategic shift -- moving to market-based pricing, with the object of the experiment being the reacquisition of market-share.
- While many OPEC members were still calling for the usual price manipulation of oil pricing, Ali al-Naimi, the Saudi Minister of Petroleum and Mineral Resources, had lived through the 1980's, when he was forced to slash production by 75% as president of the newly-created state-owned Saudi Aramco, in order to undercut new and increasing supply coming online from the North Sea, North Slope, and Mexico offshore (Cantarell). Saudi gave up considerable market share, while other OPEC members continued to produce, and oil prices remained relatively low until the first Iraq War. Never again.

Making it even more unlikely that OPEC would cut production to support prices at this point is the risk of geopolitical disruptions that could drive major aboveground bottlenecks in 2015.

- Libya is embroiled in civil war, with its central bank located in Syrian Dawn-controlled Tripoli, but with oil revenue being remitted to the UN-backed former government and rebel group controlled by Ansar al Sharia in Benghazi. Production in 2014 was estimated at roughly 450,000 barrels/day (from a pre-crisis high of 1.6 million). We expect things to get worse in the short-term before they get better.

- Iraq is still beset by ISIS, who destroyed the 300,000-barrel/day oil pipeline from Kirkuk to Ceyhan. The damage was so severe that transport out of Kirkuk may be impossible for years to come. The destruction got the Kurds in Erbil and the Shia in Baghdad to the negotiating table to sign an oil deal that alleviates some of the damage done by ISIS, but a significant short-term rise in oil exports, say greater than 500,000 barrels/day, is highly unlikely.
- Israeli Prime Minister Benjamin Netanyahu spoke to the US Congress where he eloquently questioned the merits of an Iranian deal that would eliminate sanctions and allow increased oil exports, making President Obama's long-promised nuclear arms deal more problematic. If sanctions remain, Iranian production will probably continue to gradually decline below 3 million barrels/day, while if sanctions were lifted it could be rapidly ramped up to 4 million, according to Iranian officials.
- In two weeks Nigeria will hold a postponed presidential election that pits a Christian sitting president from the Niger Delta region, Goodluck Jonathan, against a Muslim former president and military ruler from the North, Muhammadu Buhari. For three consecutive years, Nigerian production has been declining and the possibility of unplanned outages will increase in 2015. While the ISIS-aligned terrorist group Boko Haram (whose name means "Western education is forbidden") isn't in a position to disrupt oil flows, it is a serious security threat for Nigeria that Jonathan will need to deal with if he is re-elected. The Niger Delta rebels, however, are closely aligned with him. They started protecting regional oil infrastructure (instead of blowing it up) after being paid by the government as a

Production YOY Million bbl/day ■ **OPEC** ■ **Top 12 Non-OPEC**
— Saudi market share



Source: EIA, JODI, TrendMacro calculations quasi-militia. So there is a possibility that a Buhari victory would reverse the decision to hire the Delta rebels as protectors, which would lead to a resumption of large-scale rebel attacks.

- These threats make OPEC production cuts unlikely. On the other side of the OPEC production equation, if these threats materialize, Qatar, the United Arab Emirates, and Kuwait have the ability to increase production, and have invested billions to be able to bring more oil online.

While 2015 might not immediately award OPEC and Saudi Arabia with higher market-share, it sets the stage nicely for 2016. OPEC and Saudi Arabia should turn the tables and capture the lion's share of incremental demand growth, which is exactly what the Saudi strategy envisioned all along (please see the chart on the previous page).

Bottom line

The Saudi strategy to let the market determine oil prices, and increase its own market-share, is working. So we don’t expect a sudden change in policy to support prices. If production is curtailed in OPEC's several political danger-zones, the cartel has spare capacity to make it up. We are slightly raising our US production estimates for 2015, based on greater than expected momentum coming out of 2014, and a scramble for productivity. Oil prices for 2015 should remain in the $50 to $65 range, with WTI still seeing a short-term discount until refinery demand picks up after April.