Commodities Research: Crude Oil

OCBC Bank

United we stand: OPEC's 169th meeting

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Highlights

- With no change in OPEC's strategy, market-watchers turned their attention to the change in OPEC's leadership and Saudi Arabia's new oil minister. But what is significantly different from the past OPEC meetings was the relative calmness seen in the discussions.
- At the very least, the conciliatory tone adopted by Saudi Arabia paid off, resulting in not only the peace that ensued, but also market confidence that OPEC still has the ability (and unity) to play an important role in the crude oil market.
- More importantly, the outlook for oil markets to further balance itself into the 2H16 remains even as oil prices had touched their $50/bbl handles comfortably. Still, the $50/bbl may be a strong resistance handle even as the oil market rebalances, as shale oil producers turn increasingly profitable at every price uptick.

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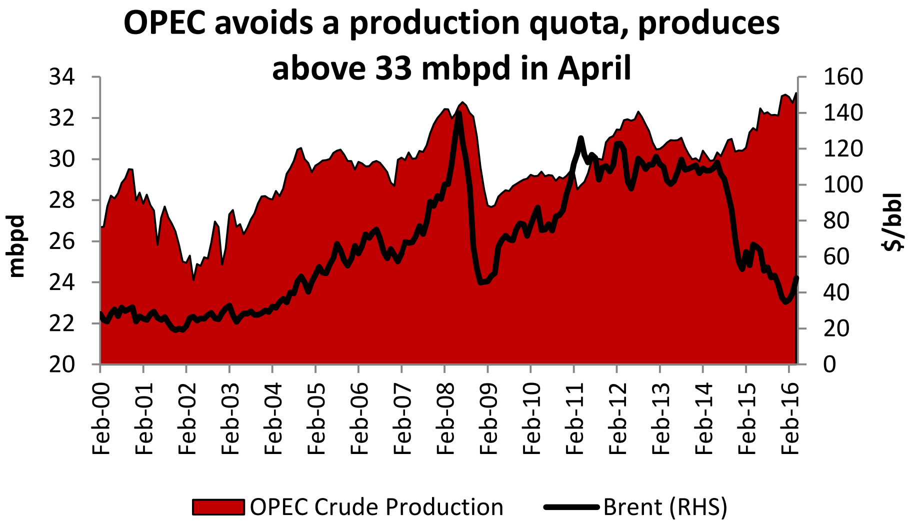
Calm without tensions

Being a new face to Saudi Arabia's oil ministry, Khalid al-Falih would likely want his first OPEC meeting to be a success. For a start, Al-Falih has big shoes to fill, given that he is at the helm of the biggest oil producer in the OPEC cartel, as well as replacing Ali al-Naimi who was Saudi Arabia's previous oil minister for more than 20 years. In a nut-shell, his agenda is perhaps three-fold: (1) to avoid the disarray seen in the last few OPEC meeting, but more importantly (2) to convince the market that OPEC as cartel can still establish unity amongst its members and (3) propel the cartel to play an increasingly important role in the oil markets.



Source: Bloomberg, OCBC Bank

Barnabas Gan
Tel: 6530-1778
BarnabasGan@ocbc.com

It could well be his debonair composure, or more likely Al-Falih's pre-meeting conferences with individual OPEC ministers coupled with cozy dinners that smoothened potential disagreements that were once present. Even Iran's oil minister, Bijan Namdar Zanganeh, commented that the "atmosphere was calm without tensions", a rhetoric symbolically important given that Tehran and Riyadh have long been in decades of disputes. Although no production quota has been agreed upon, the group had little contention in appointing Mohammed Barkindo of Nigeria to be the cartel's new secretary-general, as well as the collective approval for Gabon to rejoin the organization effective from July 1.

The lack of intransigence is indeed comforting to market-watchers, owing to the fact that a united OPEC cartel is the key ingredient to its relevance in today's ever-evolving oil market. Still, many policy proposals made by individual members were left unanswered, including Iran's call for the return of individual-member quota, Iraq's request for a collective 32.4 million barrels per day quota, as well as the attempts to talk-up oil prices by Qatar and Venezuela in which they called for a 'fair-price' of oil to be $65/bbl and $70/bbl respectively.

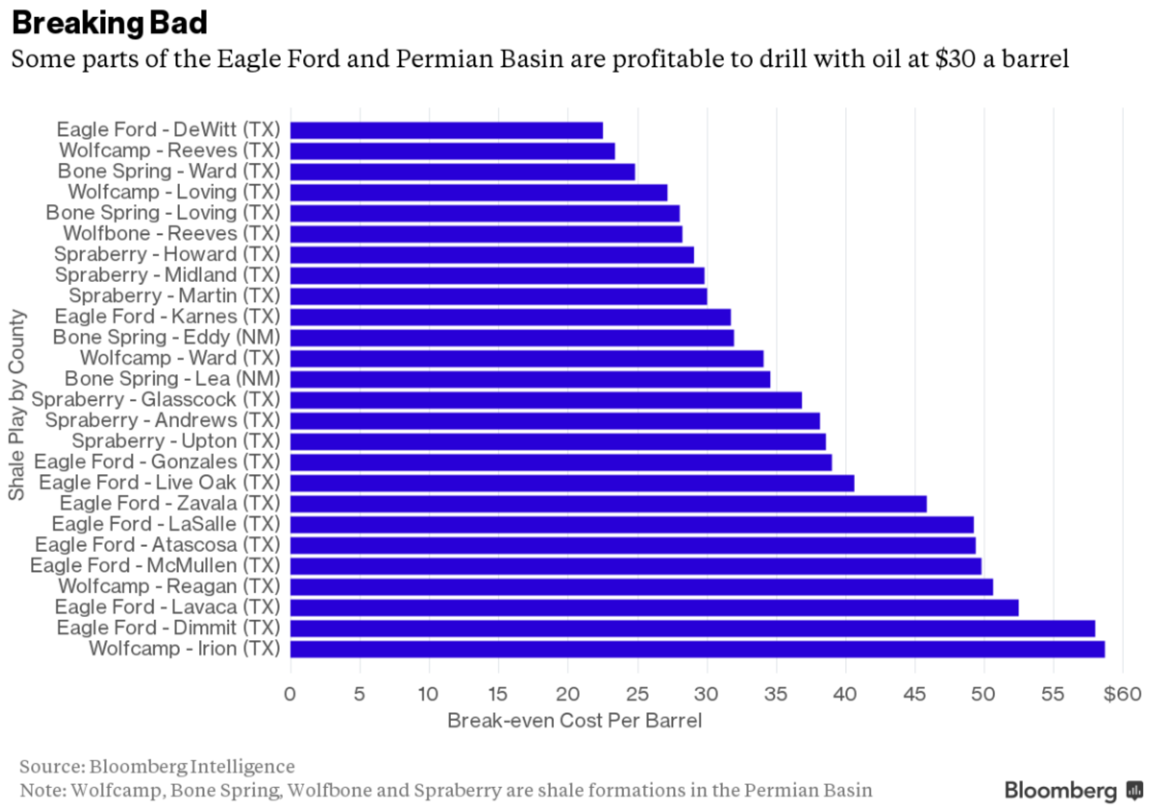
To be sure, OPEC as a cartel, works by consensus, and Iran had repeatedly rejected agreeing to a collective quota given its view that such a move is immaterial with the lack of individual-member quota. With that in mind, future OPEC meetings would likely hinge on the possibility of the return of individual-member quota even before a collective-quota can be agreed. Still, in the midst of its absence, the unity seen in the 169th OPEC meeting, though largely cosmetic in nature, is an important gesture to the oil market to show the cartel's strength in numbers. More importantly, Saudi Arabia's new-found approach to tackle tensions is comforting, coupled with its view the rebalancing act in the oil markets is set to continue into 2H16.

Ever-evolving oil market

Despite the good news seen in the OPEC meeting, it is crucial to question the sensibility of higher oil prices. To be sure, oil prices did suffer a significant slump with the sudden increase in oil supply, led by the influx of shale oil. On this, history may well be a vital relevance especially if higher oil prices re-incentivize shale oil producers to widen its taps.

Importantly, these shale oil producers had just about enough time taken to mature and grow. The shale oil boom back when oil prices were comfortably around $100/bbl when producers saw little survival need to rapidly improve and lower production cost. With the onset of the oil slump, these industry players were suddenly faced with the need to adapt or perish. This, coupled with the many years of mastering the technology of hydraulic fracturing, had created an incentive so persuasive that lowered production cost to an average of $40/bbl.

For certain, there is no one size that fits all when it comes to shale oil production cost. Simply put, production cost is a function of many factors, including the cost of drilling & completion of a well, as well as the amount of oil that may ultimately be recovered from the well itself. With time given to mature and master fracturing technology, production levels across oil wells have seen significant increases. For example, productivity per rig in the Bakken region rising from a mere 112 bpd back in January 2007, to a six-fold increase of 746 bpd in March 2016. In a nut-shell, gone were the days of high production costs for shale oil wells – these industry players had evolved through time and adapted with the sudden fall in oil prices, seen from the resilience in oil production in the US.



The falling cost of production seen in the shale-oil industry must be considered by both the OPEC members, as well as market-watchers. With oil prices already touching its $50/bbl mark, parts of Eagle Ford and Permain Basin, home to the US reserves of shale oil, are already profitable at this juncture. As such, we opine that $50/bbl may be a strong resistance handle even as the oil market rebalances, as shale oil producers turn increasingly profitable at every price uptick.

$50 is the new $100… for now

In a nutshell, the unity in the last OPEC meeting is comforting as it suggest the continued relevancy of the cartel to the oil market. Still, the fact that the rebalancing will continue into 2H16 also suggest that the oil market still remains in an over-supply environment. With oil prices touching its $50/bbl handle, one has no choice but to reconsider the return of shale oil, given that industry players are likely to be in profitable zone as oil prices recover. It is of this same consideration that we view little upside to oil prices, and a strong resistance at $50/bbl is likely to be felt especially if shale oil supplies were to be re-introduced.

We can agree that it is to the benefit of oil producers for prices to go higher. On the same note, it is of no surprise for OPEC members to try to talk-up oil prices, especially with Qatar and Venezuela in their call for higher “fair-value” for oil prices. Still, more persuasion is likely needed in order to substantiate higher oil prices, seen likely from cooperation from non-OPEC members, as well as within OPEC with an eventual agreement on an individual-member (and subsequent collective) quota system. With this absence, alongside with the sustained over-supply environment and potential return of shale oil supplies, any oil price rally may well be effectively capped in 2H16. But for now, the unity seen in the OPEC cartel is a good start, and may encourage concrete actions in future discussions.