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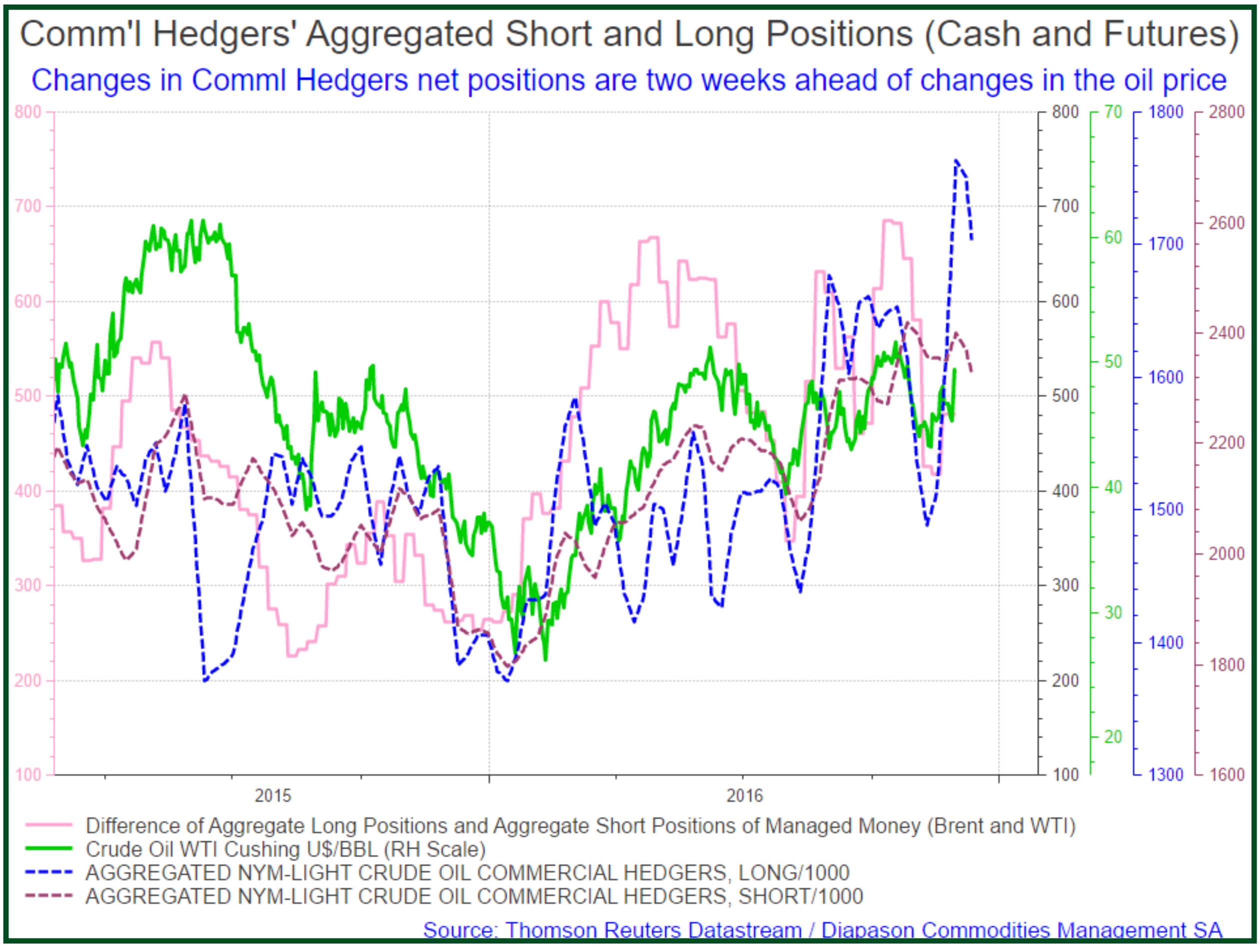
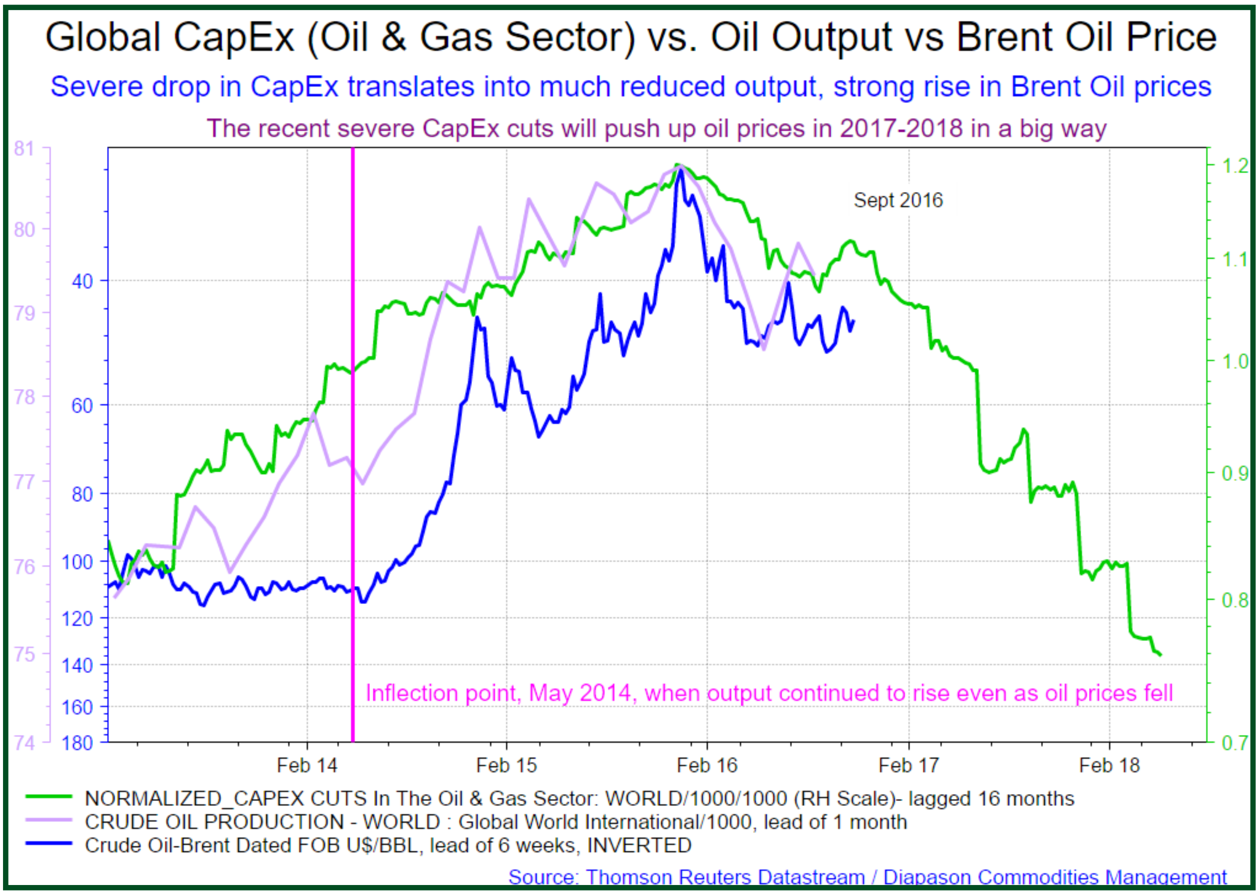
CRUDE OIL : What to expect after OPEC's decision to cut production?



After being left for dead, OPEC pulled some very sticky levers, agreed on a still-murky deal, and oil prices soared since November 30. OPEC may be back in the driver's seat, but with this what appeared to be an OPEC coup, be wary, very wary. There are many reasons not to get too delirious about the agreement to curtail output by 1.2 million barrels a day. We still do not know the other details, aside from the speculative conclusion that Saudi Arabia will be hit with the biggest cut. Russia agreed to participate in the output cut output – which actually made the deal more believable. But now comes the hard realities, post the Algiers deal -- the most prominent being the cheating of OPEC's own members. The agreement depends on self-compliance, and the commitment to cut from key countries, particularly Iraq, has been described as "weak". Iran, which was allowed to produce more, but agreed to a cap of 90,000 barrels a day, is described by veteran OPEC watchers of showing signs it could go rogue and produce more than they pledged. There are still disagreements among OPEC members on how to measure production, so the deal will be hard to implement. The next three weeks will be crucial. What commercial hedgers and shale producers do following the price rise will be key to the short-term oil price moves. There is already evidence that commercial hedgers are starting to hit the currently elevated oil prices (see graph Comm hedgers positions). We think the hedging process will start hitting crescendo once $55 is taken out. Our reckoning shows that the oil price may have to rise to



$55-$60 per barrel before drilled, but left uncompleted wells (DUCs) are reworked on a larger scale. Our read for short term oil moves: if the output cut details remain murky by mid-month, this and pressure from hedging which is sure to follow, those factors can easily create some sharp price set backs.

Nonetheless, OPEC's decision to drive down prices since 2014 has dried up Capital Expenditure (capex) flows around the world. $200 billion was removed from global energy capex budgets in 2015, with a similar amount due to be lost this year as well. Let's just focus on the actual capex which were lost. It means that $400 billion that was earmarked to keep global oil production growing roughly in lockstep with demand growth was gone. And that number will grow, and maybe by a lot, for as long as oil prices remain low (as in below $60.00 per barrel) for long. Discussion on the subject of oil well natural decline rates is a big omission on most discussions of supply-demand aspect of the oil market. Natural decline rates (NDR) globally are hard to nail down with great precision – rates vary depending on amounts of maintenance capital available and incurred, for example – but some reasonable assumptions can be made. Most studies to put the number at circa 5 percent, but we get slightly conservative, and pick on 4 percent. That simply means that each year natural declines will take about 3.6 million b/d out of the 90 million b/d production base. Or put in a better context, the NDR of oil wells globally is close to one entire shale-revolution, a revolution that took more than 5 years to develop. Our proposition therefore is that the price of oil will materially strengthen over the next few years, and that argument owes it origin to the situation explained by the graph of Global capex and oil output.