The Telegraph

Opec oil cut nears as battered Saudis bow to indomitable US shale

9 Comments

The Permian shale basin in Texas and New Mexico is becoming a huge headache for the OPEC cartel CREDIT: PERMIANSHALE.COM

The Opec cartel is poised to slash crude output after weeks of feverish shuttle-diplomacy by Saudi Arabia, halting the 'pump and dump' price war that has ravaged the oil industry for the last two years.

Officials from the cartel's 14 member states will gather in Vienna as soon as Monday to start hammering out the final details of a deal to clear the enormous surplus hanging over on the market. They have received quiet assurances from the Kremlin that Russia will play its part by freezing production.

"Opec talked themselves into a corner and they have to come away from Vienna with something," said David Fyfe, market chief at oil traders Gunvor.

"Prices could easily fall below $40 again if this ends without a deal. They need to cut by at least 1m barrels a day (b/d) to eat into inventories in early 2017."

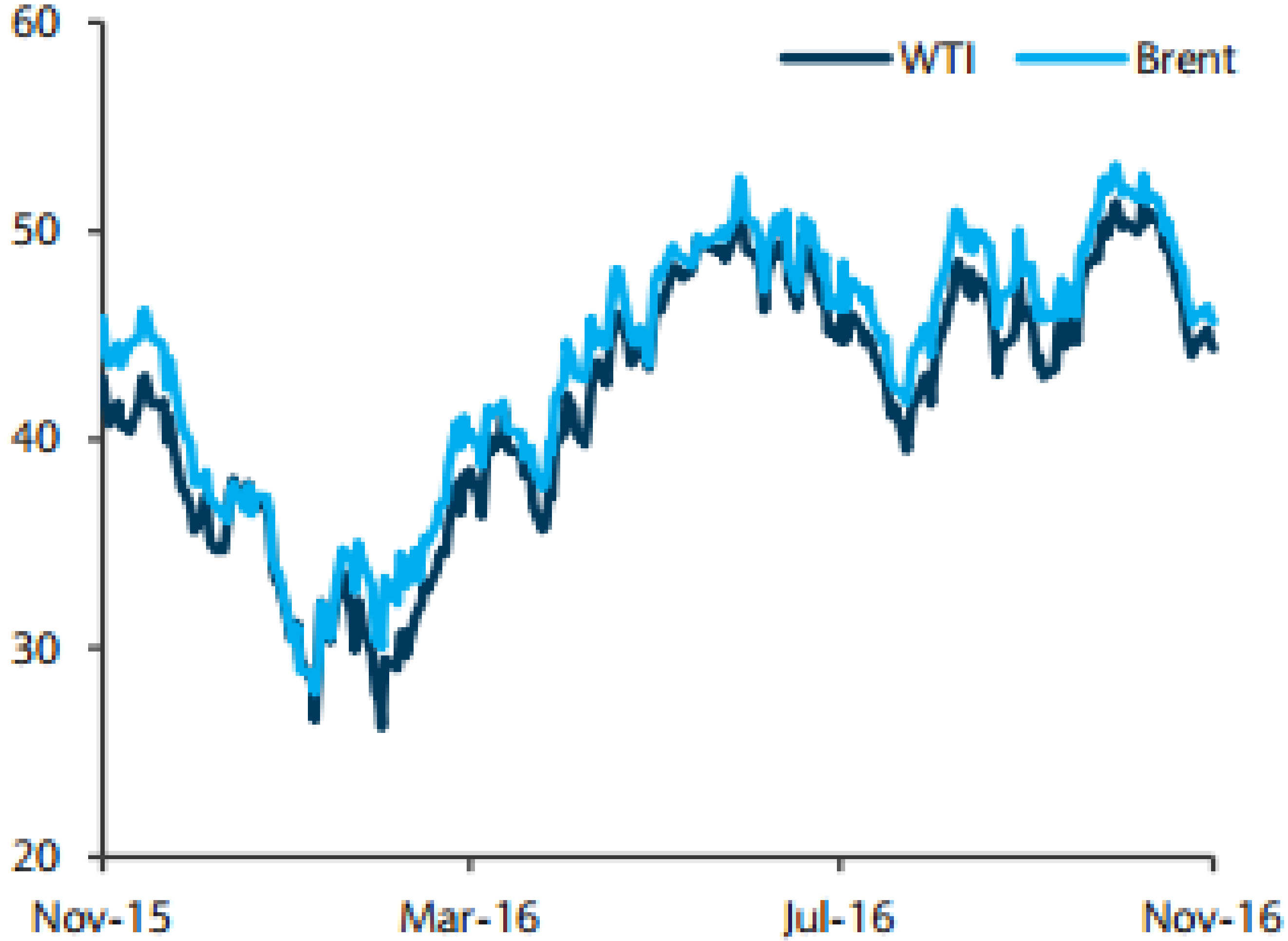
"It will be tricky: the Saudi red line is that they are not going to do this alone, and there must be some 'buy-in' from the others," he said.

Yet any break-through comes as a new report by the US Geological Survey confirmed vast quantities of cheap shale in the Wolfcamp pocket of the Permian Basin of West Texas, and as US president-elect Donald Trump vows to ease regulations for drillers and open federal land for exploration. The Permian alone could rival the giant Ghawar oil field in Saudi Arabia, ultimately producing 6m b/d at relatively low cost.

Opec faces a Sisyphean task. It must learn to live with a permanent threat from agile frackers in North America, who are able to crank output within months at once-unthinkable break-even costs, potentially capping global crude prices at half the level of the long boom years, which ended so brutally in 2014.

FIGURE 4

ICE Brent and WTI daily front-month prices ($/b)



Source: Bloomberg, Barclays Research

The oil recovery has faltered as OPEC cranks up sully and markets grows weary of empty promises CREDIT: BARCLAYS

Brent crude nudged up to $46.80 last week on optimistic talk from several Opec ministers, though prices are still down 15pc since early October. There have been hints of a loose agreement that lets Iran and Iraq taper off output slightly above current levels, leaving the Gulf states to do the heavy lifting.

"If they are highly disciplined and it doesn't all fall apart as everybody cheats, prices could climb back up to $60 next year, but that is a very big if," said Mr Fyfe. Suspicions abound that that several countries are inflating production figures to lock in a higher ceiling.

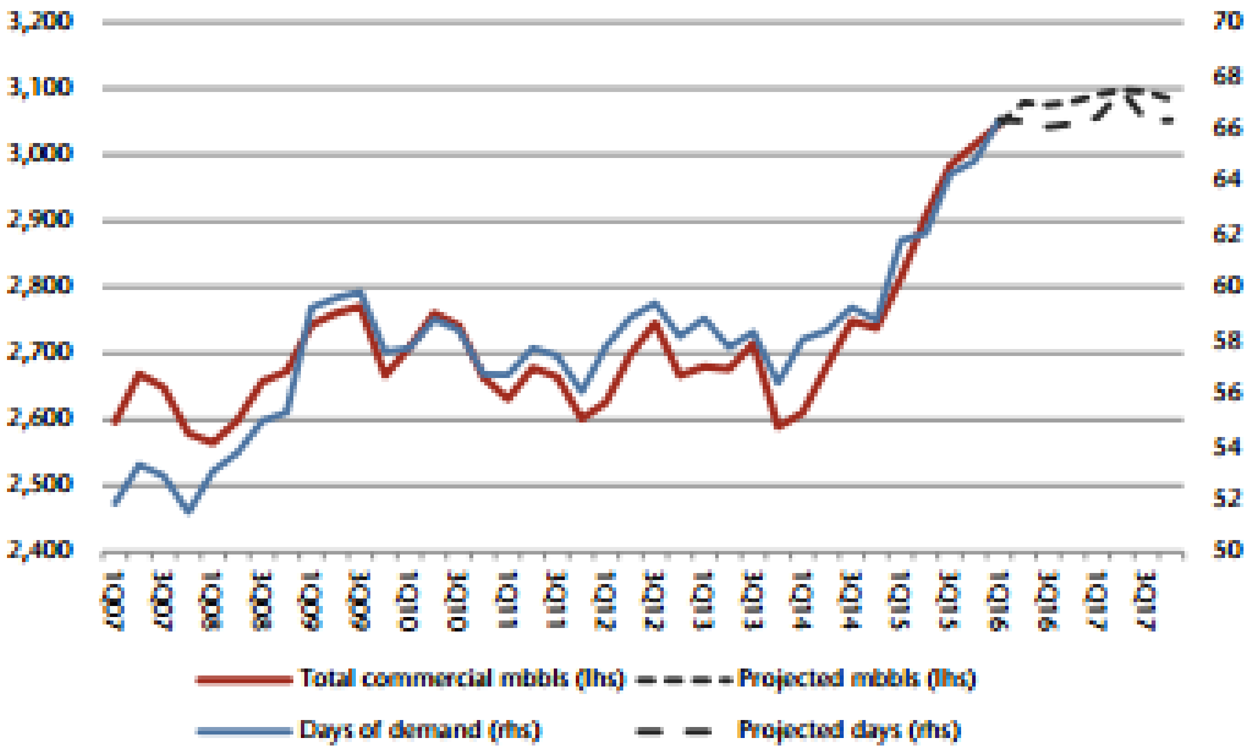
"Basically, there is going to be a deal," said Ole Hansen from Saxo Bank. "Shale is now so lean and mean that OPEC can't count on US production falling. They're only hurting themselves if they continue to pump and dump."

Opec reached a political accord in September to cut supply to a band of 32.5m - 33m b/d, vowing to flesh out the details by November 30. Failure to do so would be the final nail in the coffin for the cartel's shattered credibility.

Yet everything has gone the wrong way since then. Opec produced a record 33.8m b/d last month and the immediate glut is getting worse. Shipments from Libya and Nigeria have together jumped by roughly 1m b/d since mid-summer as attacks on oil infrastructure abate and ports return to business.

Iraq is reopening a pipeline in the Kirkuk area, and aims to boost output by another 300,000 over coming months, insisting that it should be exempt from cuts while it battles ISIS. Iran is back to pre-sanctions levels and is preparing to open three new fields with a further 200,000 b/d.

Exhibit 6: OECD total commercial inventories (mbbls)



Oil stocks are at record levels, implying a glut well into 2017 unless output is cutCREDIT: JEFFERIES

Twisting the knife deeper, the US is still drilling extra wells. The latest Baker Hughes rig count rose by two to 452 last week. Frackers have sold forward their production with hedge contracts, guaranteeing future supply whatever now happens.

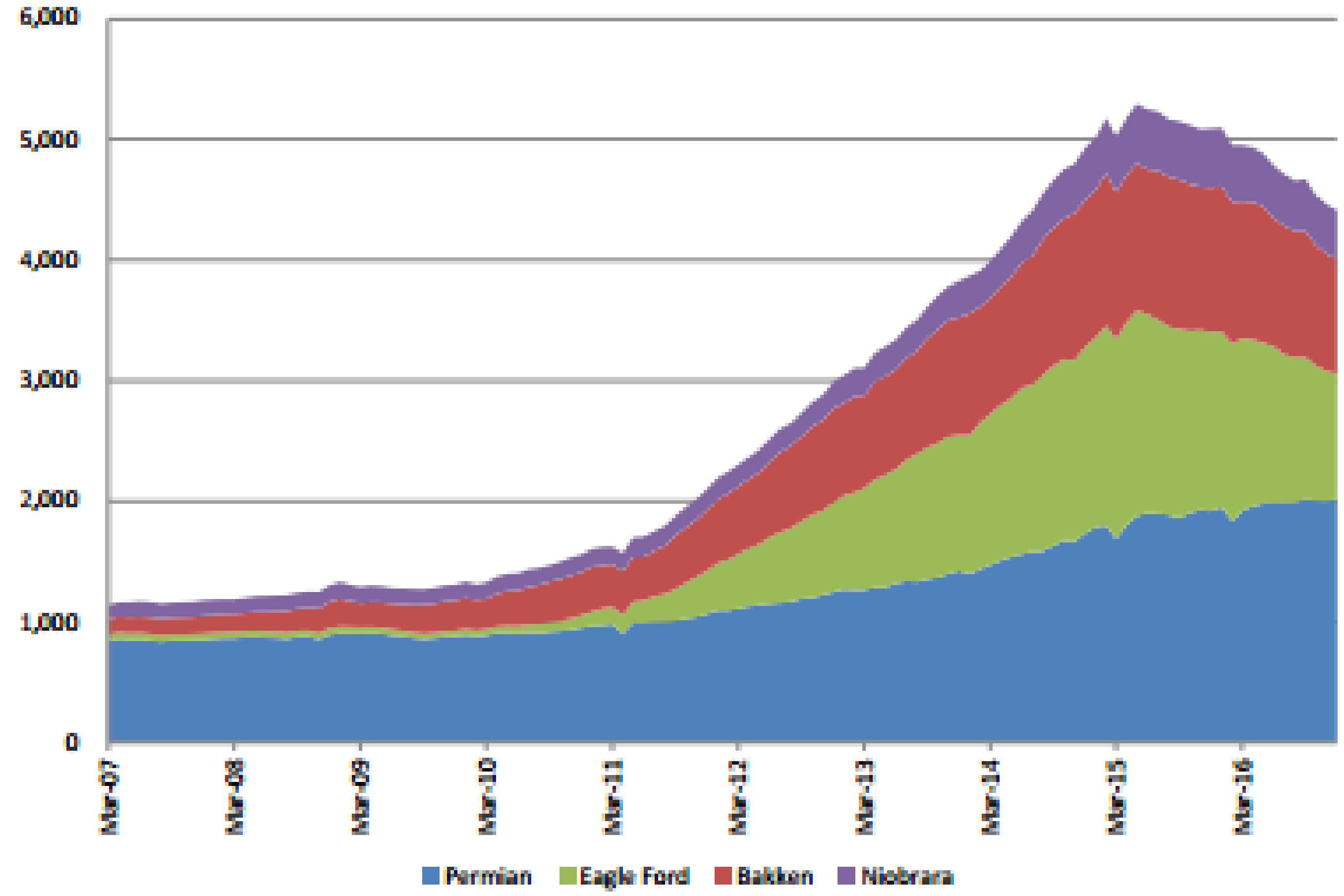
"They took advantage of the window for a few weeks when oil was higher and locked in hedges of around $52 for 2017, and $55 for 2018," said Mr Hansen.

Esther George, the head of the Kansas Federal Reserve, told an oil forum on Friday that the average price needed by shale drillers to make a profit has fallen from $79 to $53 over the last two years as technology matures. Many are making money at prices well below that.

She had a warning for those who expect a return to business as usual in world oil, predicting that a "large amount" of production would come on stream as soon as prices push through the mid-50s. "I do not see much room for price appreciation," she said.

Markets have grown cynical about Opec rhetoric on cuts. Yet it is increasingly clear that Saudi Arabia has genuinely reversed course under the new energy minister, Khaled al-Falih, and this has changed the character of the Vienna meeting entirely.

Exhibit 30: US shale oil production (kbd)



Source: EIA DPR

US shale has weathered the slump and the rig count is rising again CREDIT: JEFFERIES

The Kingdom can no longer afford to fight a grueling war of attrition to force rivals out of the market. While it has succeeded in killing off $200bn of investment in deep-water projects, Canadian tar sands, and other high-cost ventures, this has come at a very high price.

The Saudis have been burning through foreign exchange reserves at a rate of $10bn a month, and contrary to general belief their usable reserve buffer is relatively thin. They face an internal banking and liquidity squeeze, a construction crash, and have had to tap the global bond markets on a large scale to pay their bills.

"The Saudis are the ones that have suffered the biggest hit in revenue and face the most financial pain, and it has gone on a lot longer than they ever anticipated," said Mr Fyfe.

Austerity policies are biting in earnest, threatening the social contract of cradle-to-grave welfare that underpins the Wahhabi regime. Cuts in salaries, perks, and allowances have reduced take-home pay for lower level state employees by as much as 60pc in some cases.

Intelligence analysts say the Saudi-led war in Yemen is proving far more expensive than admitted, suggesting that the budget deficit is significantly higher than the official figure of 13pc of GDP. It recently emerged from Pentagon papers that the Saudis have lost 20 of their state-of-the-art Abrams tanks.

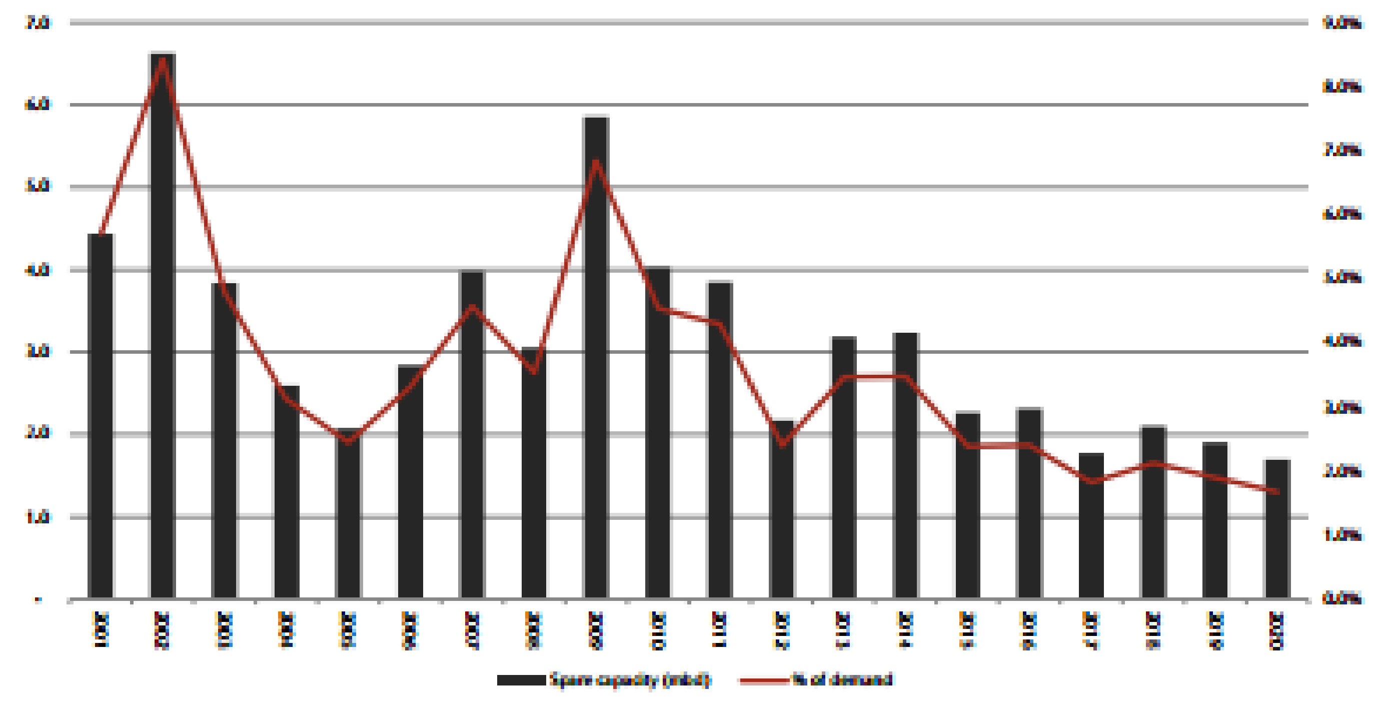
Helima Croft from RBC says the Saudis are now throwing their full diplomatic weight behind the search for a deal, though markets have not yet grasped the significance of this. If the Saudis want a deal, a deal is what will almost certainly happen.

Crucially, they need a much firmer oil price to have any chance of floating a 5pc share of state oil company Saudi Aramco for a very ambitious $100bn. The country is about to release secret details about the true extent of Saudi reserves, frozen at a constant 260bn barrels since the inception of the modern oil age - a patently absurd estimate.

"We think the Saudis want to see prices at $60," said Amrita Sen from Energy Aspects. "There is so much hardship in the Kingdom and they know what the repercussions are if there is no deal: prices are going to fall very sharply."

She said the Saudis ultimately want to keep the price in a "sweet spot" between $60 to $80, preventing it rising so high that it leads to a fresh surge of investment in renewables - the real long-term enemy.

Exhibit 5: Global spare capacity (mbd)



Source: Jefferies estimates, IEA

The paradox of the oil market is that spare capacity is wafer thin. The glut could turn to shortage very fast if anything goes wrong CREDIT: JEFFERIES

Yet the paradox of oil market today is that although it is currently over-supplied, spare capacity has fallen to wafer-thin levels as Opec states produce flat out. The Saudis have just 1.5m b/d left as a safety buffer. All it will take is a geo-strategic shock or disruption somewhere in the world for the market to tighten viciously, leading to a fresh global crunch.

Ms Sen said China's output has fallen by 450,000 b/d, Mexico is down 200,000 b/d, and deeper-water investment has collapsed everywhere. "The risk is that prices are going to react in about eighteen months. I wouldn't rule out a spike to $100," she said.

RBC suggests a flutter for the truly brave: buy deep 'out-of-the-money' call options on crude oil with strike prices of $100 and $120. You may hit the jackpot.