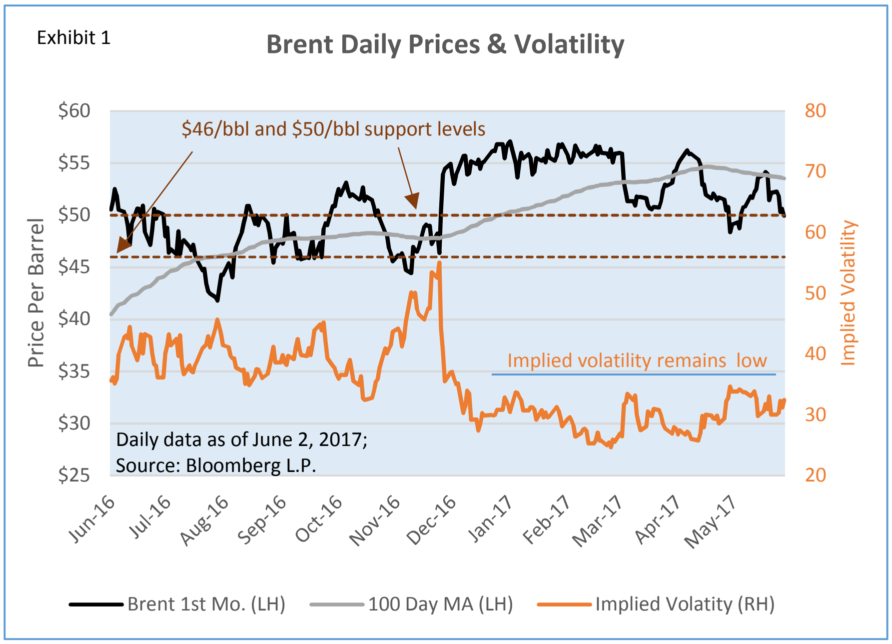
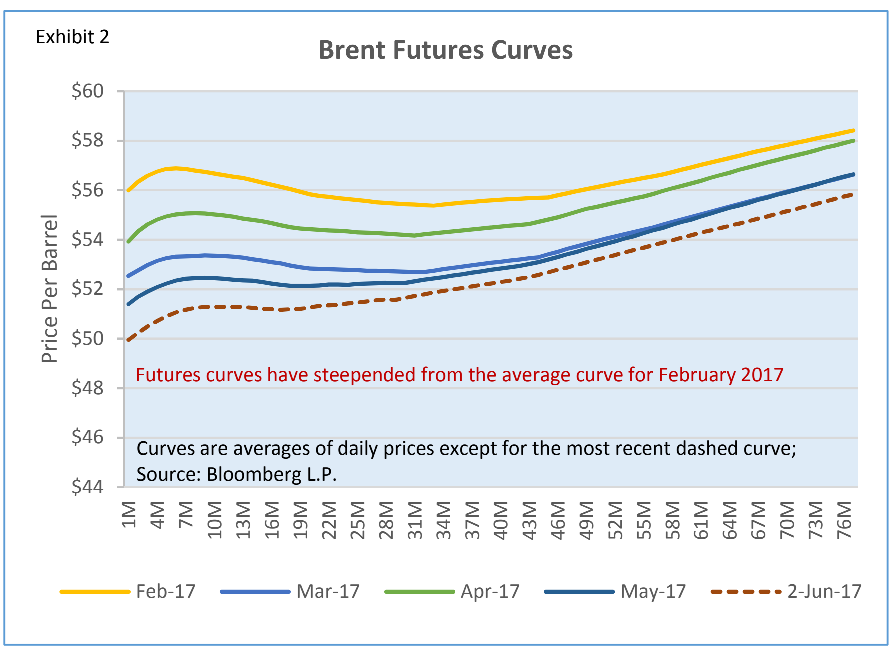
June 5, 2017

Oil Report – OPEC's Discipline to Cut Production





- Executive Summary: Oil markets remain supported by the extension of the OPEC/non-OPEC production cuts, yet recent prices indicate a test of the $50/bbl support level for the Brent front month contract. Meanwhile, there are tentative signs that production growth rates for new shale/tight oil wells are diminishing and U.S. oil inventories are drawing down ahead of seasonal demands.
- Exhibit 1: Oil prices rallied in the run up to the May 25 OPEC meeting on speculation of additional production cuts. With the announcement of only an extension of the existing cuts (1.8M bbl/day), oil prices declined 4.6% for the day (Buy the rumor, sell the news). Implied volatility has remained below average levels which ties with range bound oil prices since late November when the OPEC cuts were first announced.
- Exhibit 2: The recent Brent futures curve for June 2 has steepened as the market appears to be adjusting for a slower decline in oil inventories. This somewhat contradicts the recent declines in U.S. inventories per Exhibit 5.
- The growth rate of oil production for new wells per rig for key shale/tight oil regions in the U.S. has slowed from an average of +26 bbl/day in March 2016 to +3 bbl/day in May 2017 per data from the U.S. Energy Information Administration (EIA). As shale producers move out of their best acreage in attempts to expand production, efficiencies should be diminishing. Separately, the increase in the Baker Hughes U.S. land rig count is showing tentative signs of slowing.
- The next OPEC meeting will be November 30, 2017. At the May 25 meeting, OPEC members and non-OPEC members agreed to extend their production cuts of 1.2M bbl/day and 0.6M bbl/day respectively by 9 months effective July 1, 2017.
- Saudi Arabia's foreign exchange reserves have declined from a peak of $730B in 2014 to a recent figure of $493B (-$237B) despite having issued $26.5B of debt. The International Monetary Fund has warned that within 5 years the kingdom may run out of financial assets that are needed to support economic reform.

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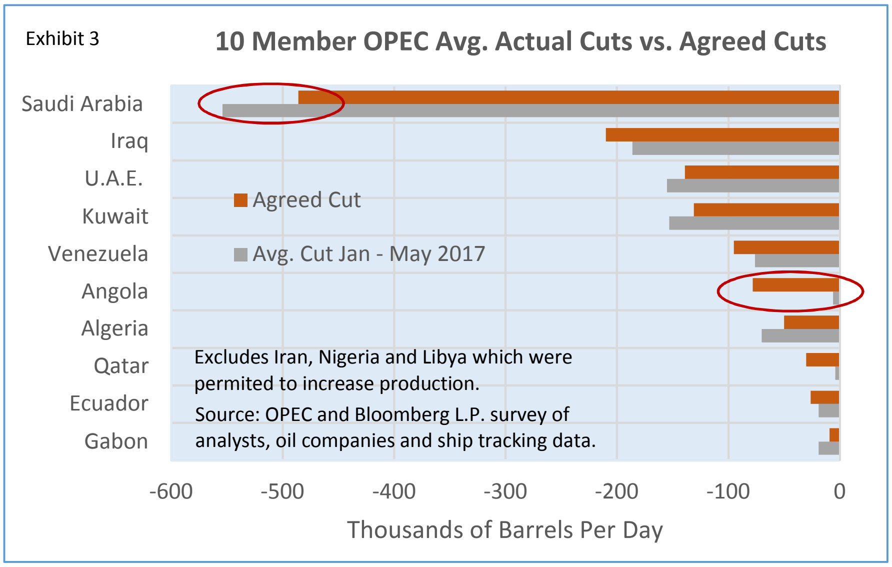

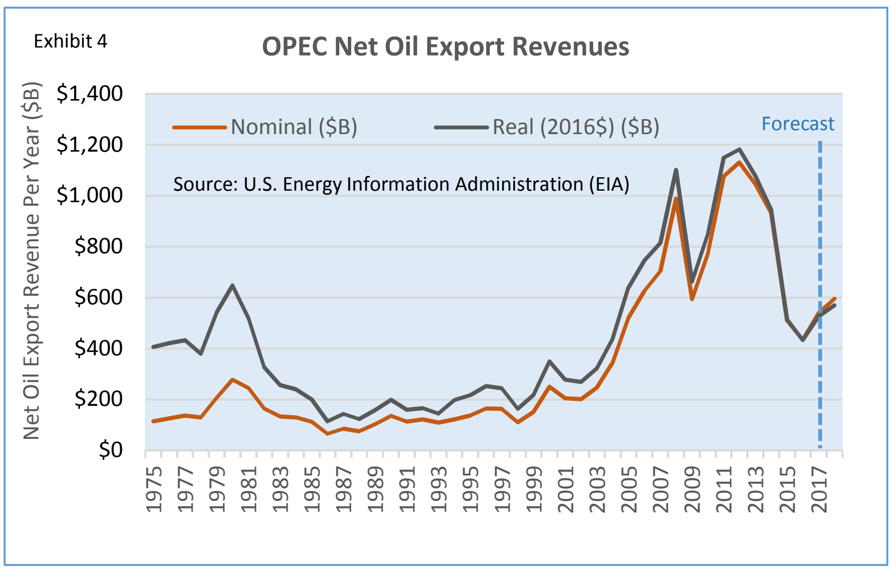

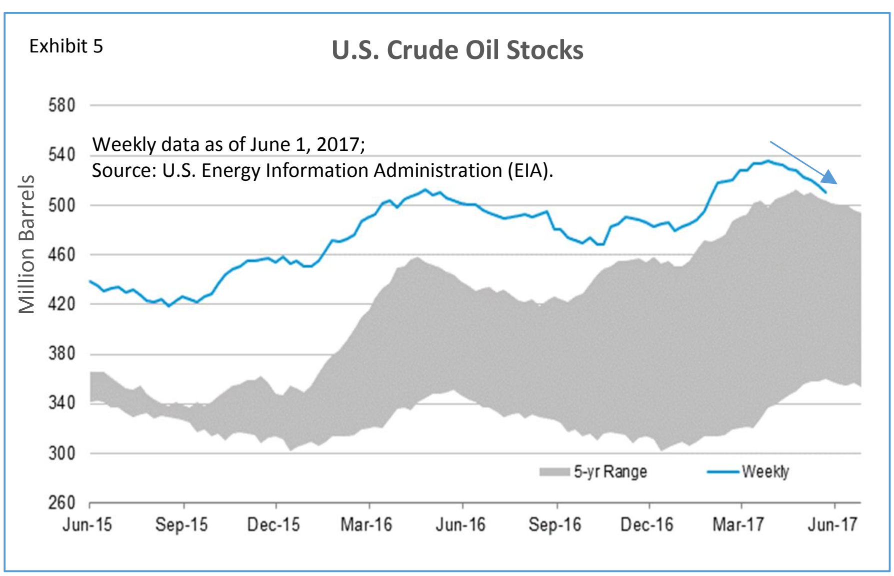

- World's largest offshore semi-submersible platform, Ichthys Explorer, has reached its destination 220 km off the north coast of Western Australia. It will be anchored for the life of the $40B Ichthys LNG project for 40 years with 28 mooring lines representing more than 25,000 metric tons of anchor chain. The platform has living quarters for ~200 people.
- Longer term deals for oil services are starting to reappear. Wood Group, an offshore focused provider of engineering, procurement and construction management services, has secured a 10 year contract with Hess (May 25), a 5 year contract with Sakhalin Energy (May 22) and a 10 year contract with Chevron (May 17). Separately, Oceaneering, a deepwater provider of engineered services and products has secured a 10 year contract for projects offshore Newfoundland and Labrador (May 25).
- Husky Energy announced on May 29 the go ahead of the $3.6B West White Rose Project. Located ~350 km east of St. Johns, Newfoundland and Labrador, the project is expected to create 250 permanent platform jobs offshore for the new wellhead. Construction is to begin in 4Q 2017.
- Offshore driller Ensco, announced May 30 the acquisition of its rival Atwood Oceanic. The agreed merger will create the world's largest jack-up rig operator with 37 rigs in addition to 26 floating rigs. The combined company has an estimated enterprise value of $6.9B.
- Exhibit 3: OPEC has reached a 103% compliance rate for the agreed 1.2M bbl/day production cuts per a monthly average of Bloomberg data from January through to May this year. Far behind on its commitment is Angola while Saudi Arabia adds credibility to the agreement by filling in the void.
- Exhibit 4: OPEC's net oil export revenue as calculated by the EIA has seen a significant pullback from the high in 2012. Despite current concerted efforts by OPEC, there is an element of 'stickiness' with their oil revenues due to high inventories. OPEC can either increase production thereby decreasing oil prices, or decrease production thereby increasing prices. One can sense why OPEC members are eager to cooperate with the production cuts.
- Exhibit 5: Could the OPEC production cuts be starting to take hold? Crude oil inventories in the U.S. are starting to see additional drawdowns and head towards the 5 year range per the weekly EIA data. For traders, this is the most up to date inventory data available and tends to move oil prices even though it does not provide an accurate depiction of worldwide inventories. There have been discussions of OPEC reducing exports to the important U.S. market thereby implying they would divert the tankers elsewhere.