STOCK MARKET MANAGER
SMM.GLOBAL
Leaders in Stockholder Communications

Oil Price Tug-of-War

By: Dave Lavigne

18 months or so ago in this column, I discussed the state of oil prices and the fact that in my view, the resurgence of domestic oil production (albeit from new shale production), may prove to be one of the major economic themes of the first quarter or perhaps half of the 21st century. I argued then that the rise of non-OPEC production and the resulting waning of OPEC influence, might create the closest thing to a "free market" for oil the the world has seen since oil became relevant. As an extension to the thought, I also suggested that as oil prices become more influenced by market forces (as opposed to monopoly pricing) they may begin trade in a more reasonable proximity to their cost of production, a notion that would probably suggest oil prices in a range closer to $40-$50 than to $70-$80. At the time of that writing, WTI oil was trading about $46, whereas today it is closer to $66. So much for my predictions.

Just to refresh, that happened to be at the front end of OPEC's contemplated voluntary production quotas, and part of my thinking at that time was that I did not believe that OPEC would be successful in gaining compliance from its own ranks, much less from non-OPEC members most notably Russia. In retrospect (at least to this point) the collective cut backs have added up to their targets. However, the way(s) they got there is another issue.

A recent Bloomberg article https://www.bloomberg.com/graphics/2017-opec-production-targets/ provides some illuminating graphics regarding the compliance of both OPEC and non-OPEC members, and as it turns out, we were largely right about the non-OPEC members. To summarize, as expected, from January 2017 through April 2018, the Russians, which represented the largest single non-OPEC curtailment commitment, complied at about 87%. The second largest non-OPEC commitment was from Mexico, which managed to curtail well beyond its commitment, cutting back about 244,000 bpd versus its commitment of just 100 bpd. On the other hand, Kazakhstan not only missed its "commitment" to curtail by 20,000 barrels per day, but instead *produced 144,000 more* bpd, effectively mitigating the gains from Mexico's cutbacks. Moreover, and this is a point I will reinforce in a moment, I am inclined to believe that Mexico's curtailments were more a function of their problems maintaining production than their willingness to curtail to help the cause.

The OPEC side of the cuts were also a mixed bag. Saudi Arabia, the largest player in this entire exercise, did comply as expected, curtailing 585,000 bpd or about 120% of its target, and other notable OPEC nations also complied relatively close to commitment. The outliers were OPEC members Venezuela and Angola. Angola's production for the period dropped 236,000 boe/d versus a commitment of 74,000, while Venezuelan production dropped a staggering 631,000 barrels (more than the entire Saudi cutback) versus a commitment of just 95,000 barrels. The problem is, I think most anyone paying even modest attention to Venezuela would concur that Venezuela's production "curtailment" has nothing to do with OPEC compliance, and everything to do with the economic and political turmoil in country. I believe the same is true of Angola. The fact is, the majority of cutbacks in oil production across the globe over the past 18

months or so since the initiation of the OPEC sponsored "agreement" has likely had less to do with compliance, and more to do with the inability of several large producing nations to maintain production. That by the way would include Iran, which is struggling to sell its oil as a result of US sanctions.

Specifically, the meltdown in Venezuela has been (and continues to be) stunning. More problematically, one has to wonder how Venezuela's problems get fixed. Given the political climate, its hard to imagine them attracting capital necessary to maintain the infrastructure and ultimately the reserves. As we noted in our April 2017 letter, "…*we fully expect further geopolitical instability to impact oil prices on an ongoing basis, and in the longer term, we also think the economic pressure that lower oil prices exert on producers who are dependent on oil to finance their governments will likely lead to lower capex, and perhaps reduced infrastructure maintenance outlays that may ultimately lead to lower production capabilities that could shuffle the supply side deck"*. Put another way, the problems in Venezuela are not necessarily surprising, but what is surprising is just how quickly the proverbial crap has hit the fan.

I recently initiated some research on a local (Denver, Colorado) based E&P company called PetroShare, and in that research I highlighted the capital-intensive nature of the oil/gas industry, and the importance of access to (and by extension, maintenance of) viable infrastructure. A dozen years ago, Mexico was the 7th largest oil producer in the world, providing roughly 3.5 million barrels of production per day. Today they produce ½ that amount, and by their own estimates will need to spend *"$640 billion to arrest a longstanding slide in production and return output to 3 million barrels per day (bpd)"*. As we noted above, Angola, has also experienced marked production declines centered at least in part on a lack of investment in new exploration, which is coming home to roost. Lastly, as I also alluded to above, Venezuela, home to the world's largest proven oil reserve, is in economic crisis and given the outcome of the recent rigged election, that is not likely to improve anytime soon. To be sure, the news out of Venezuela seems to get a little worse each day. Moreover, they are also experiencing oil asset seizures by companies like Conoco Phillips who which recently received positive rulings from international courts regarding the nationalization of assets by the Chavez regime. The fact is, Venezuela's oil infrastructure is crumbling along with the rest of the country and it is hard to imagine how after confiscating investors' assets they will ever be able to attract the necessary capital to return to their 2 million bpd production levels of just a few years ago, much less their highs of 3 million bpd in the late 1990's.

From that perspective, while I continue to believe that the emergence of U.S shale production as well as increased production capabilities from other non-OPEC countries could keep oil prices in check, the prospects of continued supply disruptions from political instabilities will also remain topical. Frankly, given some of the supply problems in unstable portions of the world, one has to wonder where oil prices might be if U.S. shale producers were not so active? It also makes me wonder whether U.S. sanctions of Iran would even be tenable without U.S. shale production. I started this article suggesting that the robust resurgence of U.S. oil production would play a major role in shaping the first half of the 21st century…and I think I will stand by that view. In any case, as (another) Reuters article recently referenced a quote from Tony Nunan, risk manager at Mitsubishi Corp., *"It's a tug of war between the loss of supply from Venezuela and Iran and the potential output increase from OPEC and U.S. shale,"*. Oil prices may be stuck between that struggle for the foreseeable future.