Oil Prices, OPEC and the Crown Prince has no Clothes

In our November newsletter write up we covered oil prices in the context of OPEC and other non-OPEC producers' decision to collude on their collective production. It's interesting how outright collusion, has become acceptable for some (OPEC for example), but is substantially frowned upon for others. A 2005-2006 investigation into price fixing by international airlines lead to jail time for a handful of airline executives and *billions* of dollars in fines. It's funny how the world works sometimes.

Since our November letter regarding OPEC's attempt to rescue oil prices, several of the questions we raised in that writing have been answered, or at least have played out a bit. As a result, we thought the topic was worth updating since oil prices remain a key cog in the affairs of the world. First, here's a recap of some of our main points from the November writing.

In order for OPEC to use output controls to boost oil prices, they will need OPEC and non-OPEC participants to adhere to agreed upon thresholds. We think that is a tall order for any extended period of time for a number of reasons. Our November call described it this way: *"if OPEC members had a difficult time staying on the same page when OPEC controlled substantial portions of the world's oil production and oil reserves, how will they possibly pull on the same oar now when they control ever decreasing portions of the same and their influence is substantially lessened?".* Actually, since November, it appears that several of the OPEC members have towed the line reasonably well, most notably Saudi Arabia, which we believe may actually have exceeded its intended cuts. (On the other hand, if the Saudi's didn't comply the who would?) However, the non-OPEC members appear to be a different story. Their compliance looks more like 60%, which the street has somehow embraced as "positive". To that end, we think www.oilprice.com hit the nail on the head: *"When is 60 percent compliance a good thing? When it's not 40 percent...".* Like we said, both in November and now, "compliance" is a difficult road.

Beyond compliance, we also noted that *"we are starting to see presentations from small domestic energy producers who believe that they can generate healthy returns on \$45-\$50 oil".* This comment is an adjunct of something we have noted in other energy related research over the not-so-distant past. Succinctly, we believe many have underestimated the resilience of U.S. producers. We think they are becoming formidable and **flexible** players in oil production and they continue to develop efficiencies to drive down costs and improve unit production. That notion seems to have some merit as domestic producers have complicated OPEC's plan to reign in supply (and eliminate surpluses stockpiles) by essentially ramping their own production much faster than most (including OPEC) anticipated.

So then, our November letter reflected three major challenges for higher oil prices; existing crude stockpiles that might keep a lid on higher prices until they were diminished, supply reductions based on compliance that we viewed as difficult to maintain and a robust U.S. oil industry that was poised and prepared to quickly fill the void created by OPEC and associated curtailment. Since then, here is what we know. Stock piles have not diminished measurably, compliance is on thin ice and U.S. production is on a tear. On the other hand, in spite of no particular data suggesting otherwise, oil did manage to trade north of \$55, and Wall Street's bets on the upside are at record levels. While we think our thesis about the challenges facing higher oil prices remain intact, oil prices have managed to rally in spite. Like we said, it's funny how the world works sometimes. The question is, as always, where do we go from here? (To be clear, oil prices *have* struggled the past week or so, perhaps providing us with some cover):

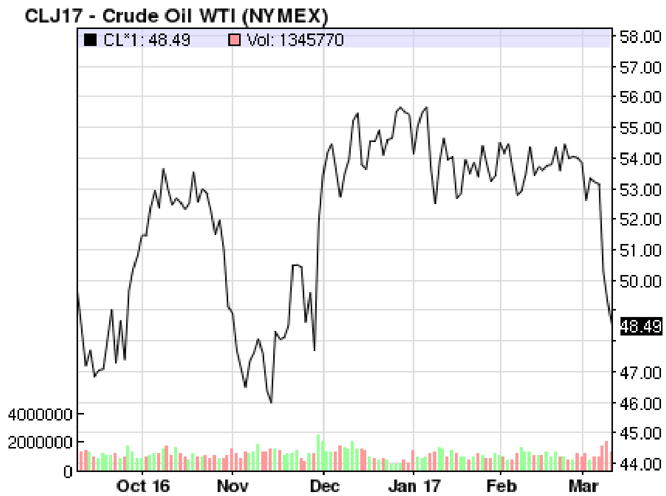

Chart from: www.nasdaq.com

Fundamentally, we think the oil industry, sooner or later, must face the brave new world where the collective influences of producers no longer predominantly determine prices. However, we submit, oil is a finite resource, and absent (additional) effective substitutes, we will, presumably, someday, likely run out of it. That is of course a recipe for higher prices at some point in the future. With that said, it seems to us that what the changing landscape of the oil patch is trying to tell us is that demand may begin to drive oil prices more than perhaps it ever has. We don't think there is much doubt that oil demand, at least for some measurable time forward, will continue to grow. There again, that notion speaks to "higher" oil prices more so than lower oil prices. The caveat to that is or course, higher than what? To reiterate another point from our November letter we also tend to believe future oil prices may become far more related to the underlying costs of production…whatever those might be.

From another perspective, we're not sure we are suggesting a sentiment that some of the world's largest oil producers are not already telegraphing. Approximately a year ago, Saudi Arabia announced its plan to start a $2 trillion sovereign wealth fund. Part of that strategy, which we have been hearing a bit more about as of late, is the public offering of Aramco, or Saudi Arabian Oil Co. We find it difficult to believe that Saudi Arabia would embark on that sort of strategy if it truly believed that it could maintain its long-term stranglehold on world oil prices. Perhaps we are simplifying this too much, but we think that is quite a tell. Of course, as the past few months have taught us, watching oil prices rise in the face of largely *failed* efforts to reduce world supply, the "long-term" doesn't seem to have much to do with it…yet.

Given the above, we see all of this as a bit of a dilemma as analysts looking for opportunities in the (E&P) microcap space. On the one hand, we continue to see evidence that supports the notion that domestic producers can continue to achieve greater efficiencies and ultimately drive unit costs lower. All other things remaining equal (read: oil prices) that would lead to better financial performance and presumably higher stock valuations. However, given our sense that $40 to $50 oil prices are likely closer to "right" than $60-$70 oil prices, it may take a sharp pencil and a keen eye to find some real gems. For our part, we will continue searching and we welcome any suggestions to that end.

-Dave Lavigne 03.13.17