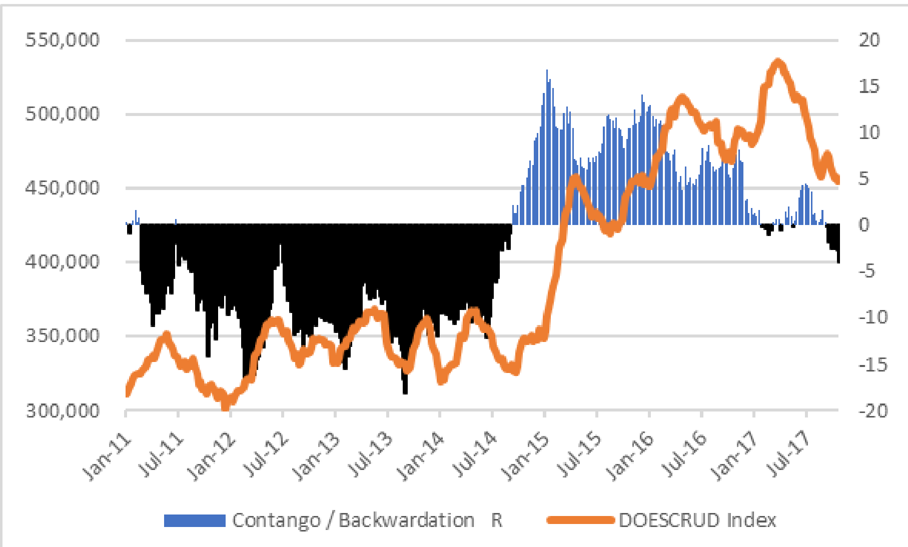
IS OPEC WINNING?

The oil price crash forced by OPEC's decision to keep its taps open in Q314 didn't kill all the shale producers, despite many no longer being cash flow positive. Contango pricing kept many afloat as the oil price structure allowed producers to forward sell at higher prices, and lenders to hedge their investments.

However, since last November OPEC has curtailed production which, when combined with robust demand, has caused an inventory drawdown. Declining inventories have pushed the oil price into backwardation. Now, with future oil prices trading below spot, shale drillers will be reluctant to open new rigs and those with insufficient capital will struggle to obtain external funding. OPEC and the oil majors gain the advantage in this environment and should recover market share. Perhaps for now OPEC has beaten the shale revolution.

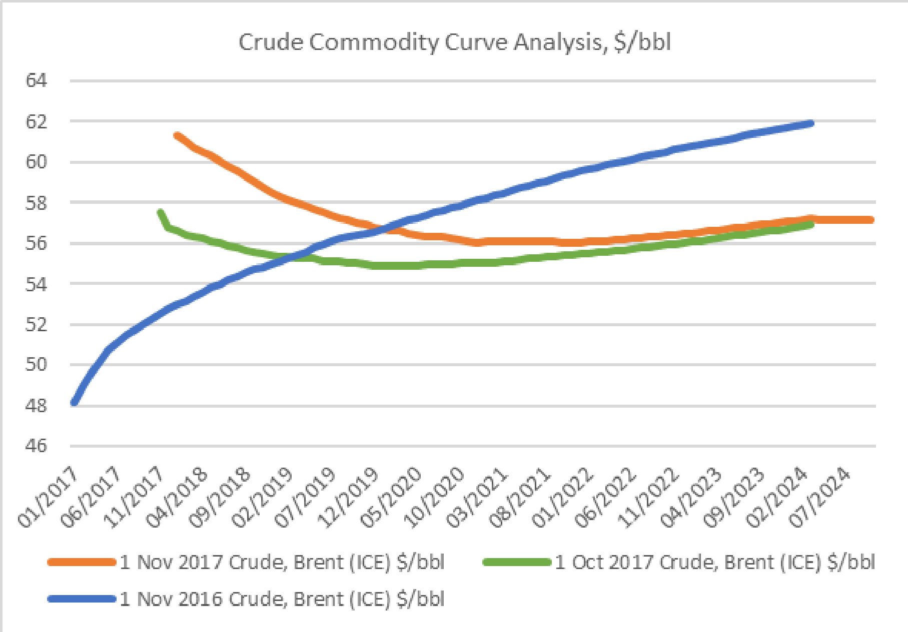
Increases in supply from Iran, Iraq and huge production growth from shale left the oil market oversupplied in 2014. OPEC decided to take on the shale industry by uncapping their production limits, causing the oil price to crash from $110 to $55 per barrel by year end 2014.

Unfortunately for OPEC, this did not have the intended effect of mortally wounding the shale industry. The resulting vast inventory build-up caused the oil price structure to switch into contango, throwing shale a life-line. With future prices now above spot, shale companies could sell oil forward, improving their cash flow, and secure external funding from investors who were able to hedge their capital. Plentiful capital kept shale functioning, while OPEC suffered from falling prices.



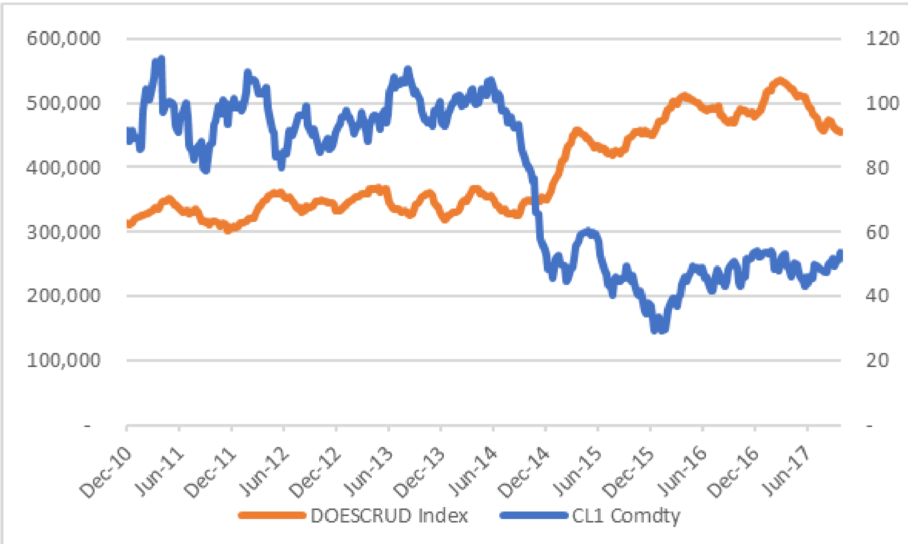
Source: Bloomberg. Backwardation is 2Y Future – Spot. DOE Data Total Inventory ex SPR, '000 barrels. Crude Price $/bbl.

However, OPEC has successfully engineered an oil price structure which is now in backwardation. One year ago, the price of oil at different delivery dates was very different, and the shape of the curve made by plotting them was said to be in contango. Compare the current shape of the oil curve below (in orange) against the shape one month ago (in green) and that of one year ago (in blue). Spot prices have risen as prices in the future have markedly declined.



Source: Bloomberg

OPEC has achieved this feat with Russia's help by limiting oil production while robust demand has meant that excess inventories are being burned through. US crude inventories (shown below in orange) are among the lowest cost in the world so reputedly the last to fall, they represent a late indicator of ongoing global inventory declines. Spot WTI crude (CL1) can now begin to rise as the market tightens, reinforcing the market's backwardation.



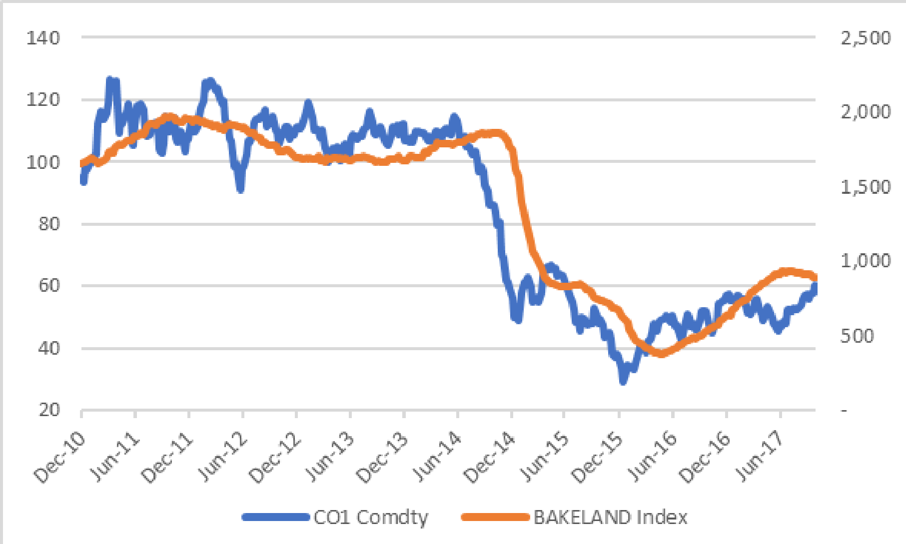
Source: Bloomberg. DOE Data Total Inventory ex SPR, '000 barrels. Crude Price $/bbl.

Backwardation's effect on hedging, limits production growth for two main reasons.

Firstly, it eliminates oil producer's ability to forward sell their output at prices higher than spot, something which has become vital for many shale players to finance capital outlays. Backwardation results in either loss making hedges, or naked exposure to a spot price which is subject to volatility. Given how highly leveraged many shale producers are, they would likely be reticent to increase drilling without first locking-in higher forward prices.

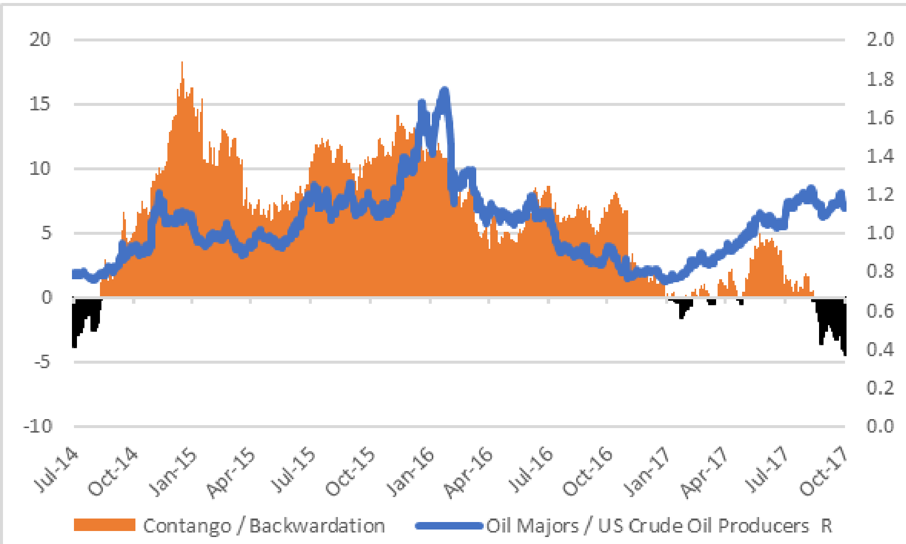
Secondly, investors who provide funding to capital-hungry shale producers would be reluctant to finance them if they cannot hedge their own investment, as many currently do. Backwardation leads to unhedged investment capital being entirely exposed to company returns. Equity markets would therefore constitute their only exit strategy, which represents a far riskier proposition. This suggest less capital should be forthcoming and in turn, output should see declines given the highly capital-intensive nature of shale businesses.

This being the case, it's very plausible that those shale producers without organic capital generation will now be unable to mobilise drilling rigs as they once did. In the high oil price environment, and the period of contango which initially followed its decline, the US on-shore rig count closely tracked changes in oil price. However, with the funding difficulties brought by backwardation, this could be set to change.



Source: Bloomberg. BAKELAND – Baker Hughes US on land rotary rig count

The implication is that shale producers which depend on outside investors to fund their activities, and forward sales to hedge their financial exposure, are at a distinct disadvantage to lower cost oil producers dependent on neither. Indeed, since OPEC's November 30th production agreement and the subsequent shift into backwardation, the oil majors (with OPEC-like characteristics) have significantly outperformed shale alternatives.



Source: Bloomberg. Oil Majors is Global Oil Majors Index / US Crude Oil Producers Index. Backwardation is 2 Y Fut - Spot

In the chart above, the blue line shows a ratio of OPEC-like oil majors divided by an index of US on-shore producers. High reserves of low cost oil that can be sold into spot markets without needing swathes of unhedgeable, fast-depreciating investment capital, should result in shale being displaced to the advantage of OPEC.

OPEC appears to be beating back the shale revolution.

INFORMATION

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