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Cut to the Chase

Oil Market Conundrum

Uncovering oil market dynamics

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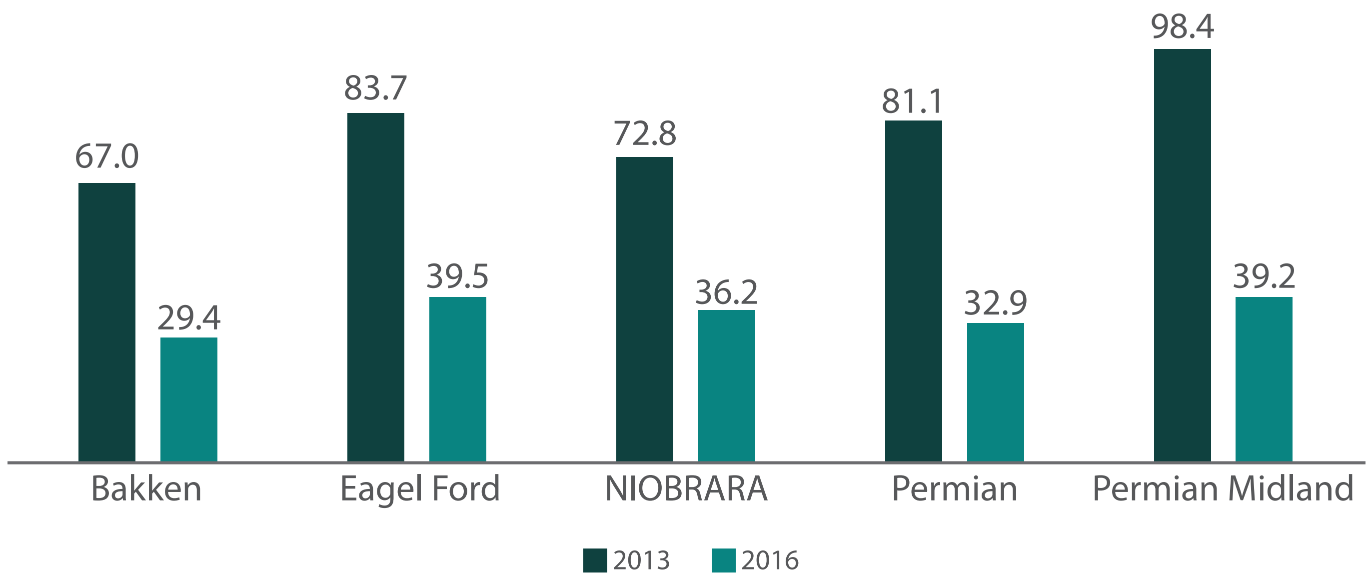
WHAT is the reason for sluggish oil price recovery?

- OPEC, Russia and other producer's output cut decision in 2016 (totaling 1.8 mbpd if fully implemented) to revive oil prices to pre 2014 level is subdued by simultaneous increase in output by U.S., rationalizing the persisting low crude-oil price.

WHY is it so difficult for OPEC to influence oil price this time?

- The sharp decline in costs due to improved technology and drilling techniques has increased the efficiency leading to rise in production of U.S. shale output even at sub-USD 50/bbl price level.

Figure 1: Well Head Breakeven oil price USD BBL/D



Source: Reuters

- U.S has 7,059 drilled but uncompleted (DUCs) wells as of July, 2017 according to EIA. Total technically recoverable shale oil reserves in U.S. stood at 78.2 billion barrels as of 2015. This implies that U.S shale-oil producers in the U.S can readily increase production and expand their market share.

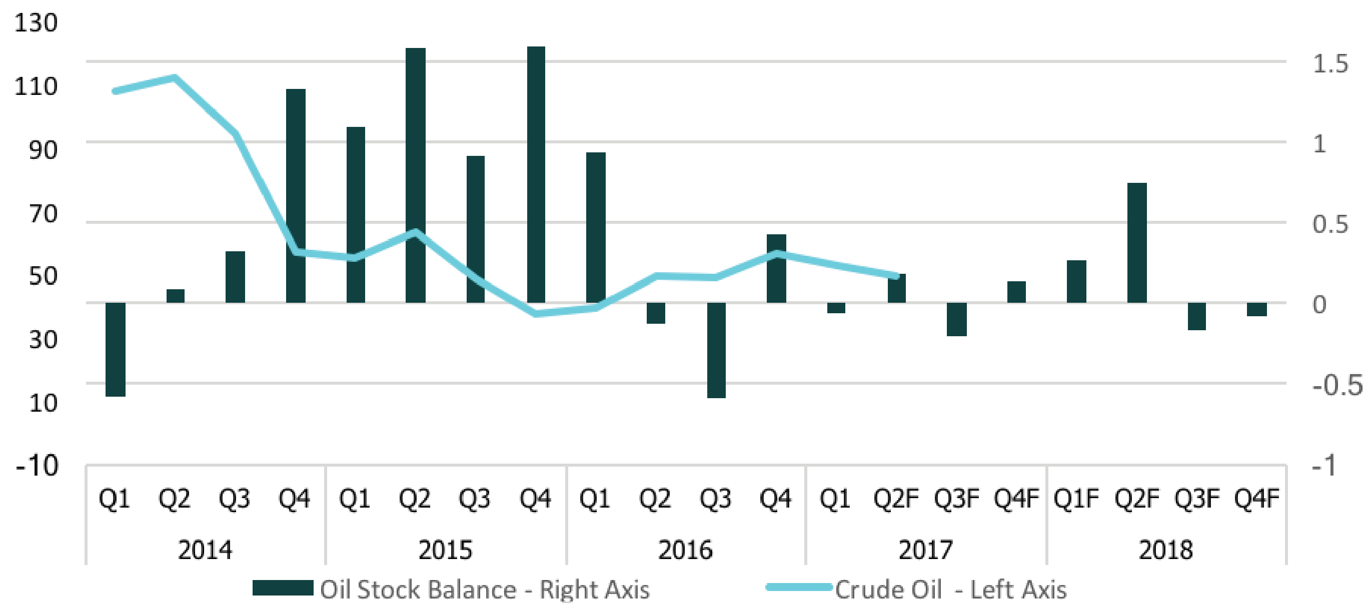
Where is demand disappearing?

- Demand from OECD and Emerging countries slowing down. China is the largest net importer of petroleum since 2014. The current transformation in Chinese economy which is oriented towards services and domestic consumption rather than energy intensive manufacturing would significantly lower the demand growth.
- Renewable energy is expected to account for half of the growth in energy supplies over the next 20 years, albeit from a lower base, mainly due to the commitment to limit emission of greenhouse gases.
- Continuous decline in electric vehicle cost is gradually making it competitive with traditional vehicle run on fossil fuel. Electric vehicles could displace more than 290,000 barrels of oil demand by 2020, 16 million barrels a day of oil demand by 2040, rising to 25 million by 2050[1].

WHEN will oil market be in equilibrium?

- OPEC'S production cut extension till Q2 2018, along with drop of 1% in US oil production to 9.25mbpd for month of June as compared to previous month to minimize the crude oil supply and demand gap in 2017.
- However first half of 2018 is expected to see surge in oil inventory as OPEC production cut tenure will mature while U.S. shale production will continue to grow.

Figure 2: Oil Stock balance (MB/D) and Oil price in USD



Source: EIA

1 *Bloomberg New Energy Finance*

Table: Brent Crude Oil price forecast (USD/bbl)

Agency	YTD	1yr
EIA	$53	$56
Goldman Sachs	$55.4	$58
Bank of America Merrill Lynch	$50	$52
BNP Paribas	$51	$48
JP Morgan Chase & Co.	$55.8	$45

Source: JP Morgan website, EIA, ET, GS Research

HOW GCC countries should position themselves for future?

- OPEC participants have already achieved 106% of their required cuts, while non-OPEC compliance was 64%[1]. In the short run OPEC led by Saudi should try to accomplish compliance from Non-OPEC members and invest in shale companies. Only a coordinated effort from all three players (OPEC, non-OPEC and shale producers) can bring back the equilibrium to the oil market.
- Vulnerability to oil price fluctuations reveal the importance of economic diversification in the long run.
- Government should therefore continue to cut down spending and minimize the subsidy, particularly for petroleum products.
- Introduction of VAT will boost the non-oil revenue. Recently indirect taxes in connection with expatriates is also expected to diversify the revenue streams.

1 *Bloomberg*

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