

## Learning from the past – OPEC’s real strategy

*OPEC’s strategy is less about “Sheiks v shale” as The Economist<sup>1</sup> might have you believe, but rather a replay of what they learnt from 1999.*

OPEC can afford some of the best minds in the business and looking back to the period 1999 – 2008 they’ve learned a lot.

First, they learned that a period of low oil price was a significant deterrent to exploration and production development amongst non-OPEC producers. They saw this in 2004 with majors reporting sub par reserves replacement.

Second, they learned that (conventional) production rebounds but slowly after a hiatus. Most of the 2000’s saw oil companies chasing to catch up as demand outstripped supply, with a subsequent upward spiral of development cost and schedules.



Third, they learned that in a climate of falling oil price, OPEC members will fight each other to secure their share of the available revenue – up to a point. In 1999 that point was reached when the price touched \$10/bbl and the majority of OPEC government ministers realized that their existence (and probably their own lives) were at risk unless they do something to stabilize their fiscal balance. Cutting government spending was untenable, lest it ferment revolt, so they needed to co-operate with their oil producing brothers to cut production to raise oil prices and thus revenues.

For OPEC their actions in 1999-2000 worked a treat – for the next decade they enjoyed record revenues, their position on the world stage was secured and they had the financial freedom to satisfy the needs of their people. For the decade to 2010 the average price was more than \$50/bbl, almost three times that of the previous decade.

So, faced with a similar challenge in 2014 it should be no surprise that they might reach for the same tool kit – increase production / fight for market share and watch the price decline (done); take note of exploration spending cuts and project deferments (in progress); move to a consensus to rein back production to rebuild prices (next steps?) ; reap the benefits for another 5 – 10 years as the industry again chases to catch up.

And so far, so good: \$200 bln plus of projects deferred or cancelled at last count<sup>2</sup>, exploration budgets slashed, staff laid off. A back of the envelope estimate of

<sup>1</sup> December 6<sup>th</sup> 2014 edition

<sup>2</sup> “Oil majors rush cuts to hit \$60 break-even”, C. Adams, Financial Times, 28 October 2015

announced deferrals or cancellations implies circa 3 mln bbls/day production that does not come to market in 2017-2020 window<sup>3</sup>.

### **Unconventional Option**

However, this time it might be different. What has changed has been the growth of US shale oil. And here the big difference is the business model.

Each of the thousands of wells drilled to develop a shale oil resource provides the developers with options: drill now or later, drill a simple or complex well, minimal or maximum fracking, complete, hook-up or suspend, etc – a very different ability to manage oil price risk and cash flow compared to conventional oil development.

Compare that to the on/off decision facing say a deepwater or oil sands development – a multi billion dollar decision to commence construction or put the project back 18-24 months, which if proved wrong could cripple a company.

So, as oil price drops US oil shale rigs are put in mothballs, wells are suspended. Meanwhile new technology and processes to reduce cost are quickly tested and embedded as best practice through the eco-system of service companies and competition.

Even if the majority of current US shale oil companies are forced into liquidation by low oil price, the wells, infrastructure, rigs and capabilities remains in place. The response time should economic conditions improve would be measured in weeks and months not years.

If OPECs advisors see the same, then their current strategy makes sense if these key assumptions are correct:

- Cancellation of conventional exploration and “mega-project” will take out sufficient production capacity to rebalance supply-demand.
- US Shale oil, while resilient, remains an exception and is a finite resource.
  - No other shale oil play (e.g. Argentina) is likely to develop as rapidly or as nimbly as the US<sup>4</sup>.
  - The marginal cost of US shale oil will increase as the sweet spots are fully exploited and technology gains reach diminishing returns.

If so OPECs strategy is less about “Sheiks v shale”, but a replay of what they learnt in 1999 about non-OPEC conventional production.

### **OPEC’s \$600 million (per day) question**

Another unconventional characteristic of US shale oil is the financing model. A vibrant pool of energy lenders and private equity provide reserves-based loans to many producers. This model obliges the producers to hedge a portion of

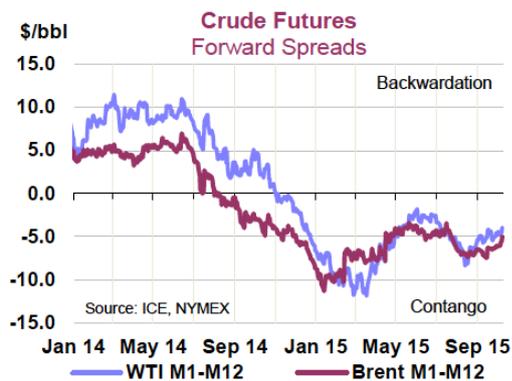
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<sup>3</sup> There is a range of estimates in regards the impact of deferrals on production. The Financial Times (6 November 2015) reports Energy Aspects as expecting 5.2 mln bbls / day deferral, while Wood Mackenzie analyzed 465 projects to estimate 2 mln bbls/day in 2021.

<sup>4</sup> There are many reasons why this is so, for gas as for oil, but best summed up in the comment “In most places the landowners call to complain when the drill rig arrives on their property. In the US, landowners call to complain when it does not.”

production, perhaps up to 60%.

As can be seen in the graph (right), as supply exceeded demand in late 2014 the market moved from backwardation to contango where spot prices are lower than futures prices. For producers selling 6- to 12-months forward, contango provides a welcome boost to their profits of \$5-10/bbl more than they might have otherwise achieved, outright oil price movement notwithstanding. The consequences of this hedging obligation has been seen in both the US oil and gas markets where drilling and production development continued apace despite the spot prices below the marginal cost of development – in essence the producers plan their business on their hedged forward price, not spot.



However, as supply and demand move back into balance and stocks decline, the market will return to its normal state of backwardation. Here the converse applies for producers obliged to sell forward – they could be \$5-10/bbl less well off. Furthermore, to add insult to injury wellhead royalties are calculated on spot not forward prices meaning a larger share of cash flow going to the royalty recipients.

Simplistically, US shale oil producers currently sees revenues as if the price was \$50-55/bbl despite the spot price being close to \$45/bbl.

As demand and supply rebalance, unless their lenders accept different hedging strategies, it can be expected they will continue to see the same \$50-55 price even with spot prices at \$60-65 as the market shifts from contango to backwardation.

So how clever are OPEC's advisors? Might they be able to finesse the market to lift spot prices and thus avoid fiscal meltdown amongst OPEC countries, without unleashing a shale gale? Might they, like in 2000, explicitly signal to the market their oil price aspirations – spot price at \$60-65, futures price at \$50-55/bbl ?

Or are we facing a period of amplified price and production volatility as US shale producers respond to futures rather than spot prices, creating an increased disconnect between supply, demand and stock levels?

**About the Author:**

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John has 24 years oil & gas experience, having worked in Europe, UK, Australia and SE Asia. His initial career was spent with Shell where he progressed through a variety of technical and operational roles into commercial, economics and strategy roles. With Shell and more lately with Mubadala Petroleum he has been responsible for new business development, deal delivery and regional commercial management. As well as upstream commercial and joint venture expertise he brings niche expertise in LNG supply and particularly Floating LNG. John has a PhD in chemical engineering and is a chartered engineer.

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