Sustainability Research

Kepler Cheuvreux

ESG Alert

23 March 2015

# Saudi Strategy Working as US Oil-Rig Count Drops Further (Now Down c.50% since October)

**Why this Alert?:** After a stronger tone to the end of last week, oil prices are weaker again this morning after Saudi Arabia's oil minister, Ali al-Naimi, re-iterated yesterday that neither the Kingdom itself nor OPEC would cut output to prop up oil prices unless other non-OPEC producers also took their share of responsibility for re-balancing the market. In our view, this statement from Minister Al-Naimi should not be a surprise, as the Saudis have been very consistent in their stance ever since the last OPEC meeting in late November last year. The clear Saudi position is that they want to retain market share and that low-cost producers (such as Saudi Arabia) should not cut output ahead of higher-cost producers (such as US shale-oil producers). Indeed, we think the Saudis are all the less likely to cut output in the near term given that their strategy of favouring market share over prices now appears to be having the desired effect on US shale producers: the US oil-rig count fell yet again last week, and is now down by nearly 50% in five months, while as we highlighted last week (see our Alert of 16 March, *Oil under Pressure but is US shale-oil supply already falling in the Bakken?*) shale-oil production in the key Bakken play actually fell in January versus December. We acknowledge that negative sentiment with regard to rising US crude inventories and current US dollar strength could keep prices subdued in the short term, but we remain of the strong view that the fundamentals with regard to US shale-oil are looking increasingly negative and hence that US oil supply will stall by the middle of this year (or perhaps sooner), thereby paving the way for a sustained rally in oil prices over the second half of the year and a Brent price at year-end 2015 of $75/bbl.

**Oil price remain volatile:** Figures 1 & 2 show the evolution of the front-month Brent and WTI contracts over the last week. Prices remain volatile, with both Brent and WTI trading in a $4/bbl range last week, reflecting in our view the battle between market bears focused on the continuing build in US inventories, and market bulls expecting the sharply reduced US oil-rig count in recent weeks to start having an impact on shale-oil production sooner rather than later.

**Figure 1: Brent front-month price, 16 March-23 March 2015** **Figure 2: : WTI front-month price, 16 March-23 March 2015**

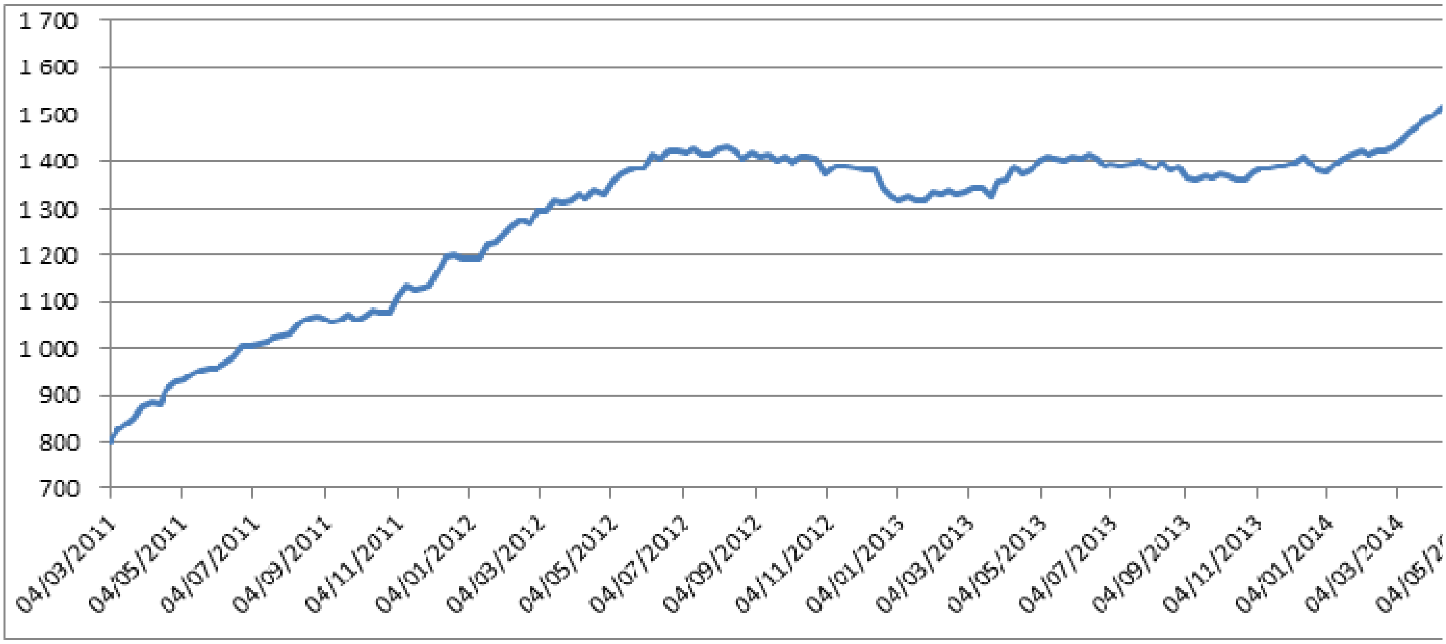


***Source:***

***Eikon***
***Source: Eikon***

**<u>US rig count down again last week:</u>** The Baker Hughes US oil-rig count fell by another 41 units last week to 825, and is now down by 784 units (49%) in only five months against the all-time high of 1,609 recorded for the week of 10 October last year. As can be seen from Figure 3, it is now at its lowest level since 4 March 2011. The scale of the drop since late December in particular is spectacular, with 657 of the total 784 rigs dropped since 10 October coming off since 2 January.

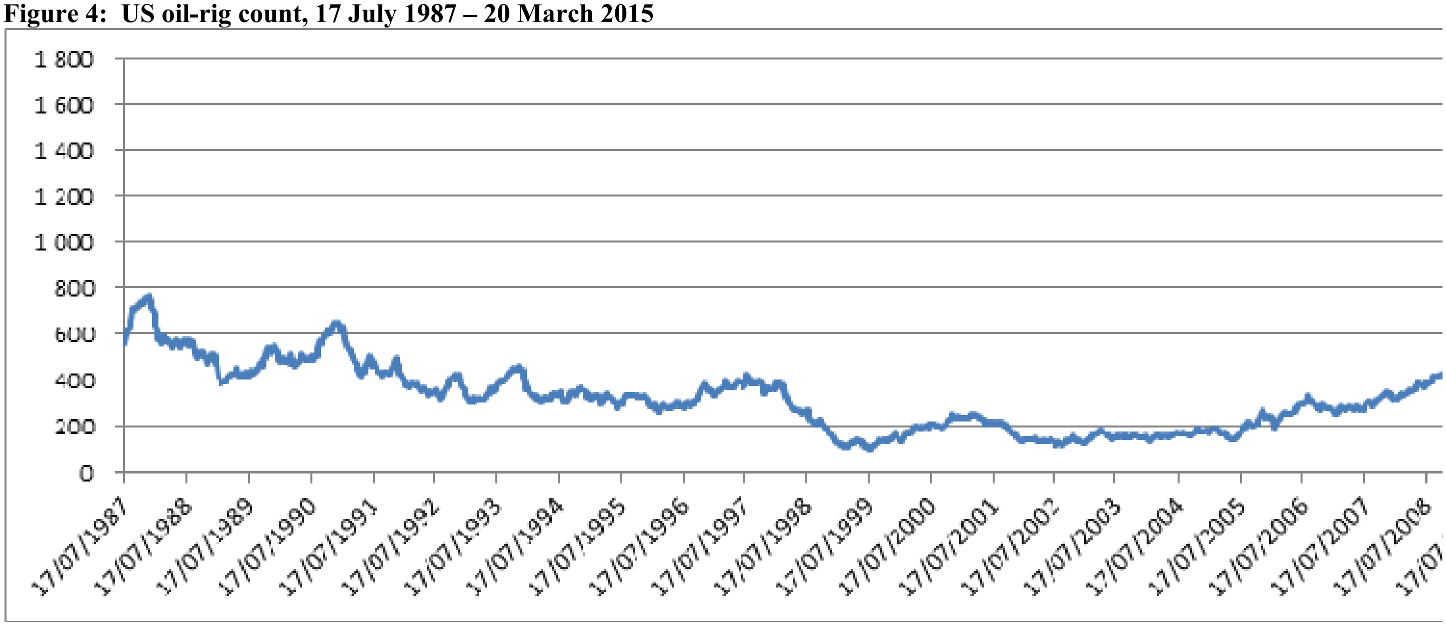
**Figure 3: US oil-rig count, 3 March 2011 – 20 March 2015**




***Source: Baker Hughes***

Indeed, the sheer scale of this drop is unprecedented, as becomes clear when we take a look at the entire Baker Hughes weekly time series for US oil rigs, which goes all the way back to July 1987. As shown in Figure 4, there is no historical precedent for a drop of anything even approaching this speed or severity: quite simply, the US oil-rig count has fallen off a cliff since the beginning of this year.

**Figure 4: US oil-rig count, 17 July 1987 – 20 March 2015**




***Source: Baker Hughes***

**Why does the US rig count matter so much?:** The US rig count matters because it is a leading indicator of US supply. For the moment, our expectation remains that despite the precipitous and ongoing drop in the rig count US shale-oil supply will continue to grow until the middle of this year owing to the fact that (i) a significant proportion of 2015 output has already been hedged at much higher prices, and (ii) hundreds of wells have already been drilled but not yet completed (meaning that a reduction in this backlog will likely have to occur before production growth starts to slow). Ultimately, however, we expect the dramatic fall in the rig count and hence in the number of new wells drilled to impact shale-oil output from late Q2. Indeed, the most recent data released by the Oil & Gas Division of the North Dakota Industrial Commission may signal that supply from the key Bakken shale-oil play is already stalling. As we highlighted in our Alert of last week (*Oil under Pressure but is US shale-oil supply already falling in the Bakken?, 16 March),* January oil production in North Dakota was 3% lower than in December (1,190,490 barrels per day compared with 1,227,483 barrels per day respectively). Of course, this is only one month's data, and we will have to wait and see if production figures for February and March confirm the trend. On the face of it, however, what seems to be happening in the Bakken is that as the oil price has fallen in recent months so too has the rig count, with producers drilling fewer new wells and also reducing the number of new well completions. If these trends are confirmed in the February and March data, shale-oil supply from North Dakota may start falling earlier than we have hitherto been assuming.

**Bottom line:** The Saudis remain firm in wanting to maintain the pressure on US shale-oil producers, and we think their policy is now starting to bear fruit as the falling rig count appears to be impacting output in the Bakken. Although oil prices will likely remain volatile in the next few weeks until the trend in US shale-oil production becomes clearer, we expect stalling US production by the middle of this year, and hence a sustained price rally from late Q2/early Q3. Indeed, we think the market should be watching the oil-production data from North Dakota particularly closely in the next few weeks, as the data for January indicates that production there may already be stalling. If a declining trend in production from the Bakken play in North Dakota is confirmed in the February and March data, we think this would be a leading indicator for US shale-oil supply more generally. As explained in our in-depth report Oil's New Crude Reality, we expect Brent to reach $75/bbl by the end of 2015.

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Kind regards,

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