



Oil Macro: Recovery gains stronger footing

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OPEC vs US Tight Oil: Round 3?

- Falling US tight oil breakevens have not ruined OPEC's game plan. So far, it has been remarkably successful in managing the difficult task of both holding on to market share gains since 2014 and also establishing a floor under prices, all while facing a tight oil industry which is becoming ever more efficient. We expect that the abiding interest in maintaining market share will make OPEC's Dec-18 extension the last.
- One theory holds that Saudi Arabia's difficulty in further lowering its fiscal breakeven (USD 77/bbl, down from USD 107/bbl in 2014) means that it would prefer overshooting on the oil price. However, we believe the fear of re-incentivising another wave of strong supply growth in the US must factor equally into the calculus, especially since well productivity growth shows no signs of leveling off yet. Additionally, the risk of denting demand and driving consumers to purchase more fuel-efficient vehicles should also reduce the interest in deliberately sparking an overshoot.
- Visibility on US supply growth remains poor. Analysts were asked to present on US tight oil to OPEC on 24 Nov and offered tight oil growth outlooks ranging from +500kb/d to +1.7mb/d in 2018. Our view on US supply growth tends towards the lower end of the range at +773kb/d tight oil and +940kb/d total liquids, although we have raised this by 100kb/d on expectation of a recovery in rig productivity. Sensitivities to the WTI price range from +539kb/d tight oil in the case of WTI averaging USD 45/bbl, and +1,113kb/d tight oil at USD 65/bbl.
- Tight oil breakevens are likely to rise as long as the rate of completions is held back by insufficient capacity. We expect that the completion bottleneck will show signs of being loosened by the end of Q1-18 as newly commissioned frac capacity begins to be employed, and an orderbook

of 0.5-1.0 million hydraulic hp begins to be delivered over the course of the first quarter. This risks lifting productivity as the completion rate rises toward the drilling rate, reversing the move initiated in September 2016. Cost inflation is likely to be modest as US frac pricing remains subdued at ~60% of the 2011 level.

- The economics of non-OPEC pre-FID projects shows a decline in full-cycle costs from USD 53/bbl to USD 46/bbl over the last twelve months. Deepwater reserves still contribute the most reserves by resource theme, and we see USD 65/bbl as the marginal cost of new supply from oil sands projects.

Six-month rally beginning to look mature

- The six-month rally in the crude oil price is now in danger of being overextended if prices were to rise beyond USD 65/bbl in our view, a level reflecting the cost of new oil sands projects. A key driver has been falling US supply growth forecasts, a trend which we believe is now poised to turn around. In addition we see a modest global oversupply in the first quarter, slowing the pace of inventory declines. Although Saudi Aramco CEO Amin Nasser states oil prices are in "continuous improvement" we believe the road will be more rocky. We see US supply growth as the next (unquantified) bump in the road in 2018, followed by OPEC expansion in 2019, before we come on to the first substantial deficit of roughly -750kb/d in 2020. Only then do we see potential for prices rising above the equilibrium defined by marginal full-cycle project breakevens.
- In the next sections we describe (i) the reasons behind the next wave of optimism in US supply growth, (ii) how we might expect US supply to respond to various oil price levels in 2018, and (iii) how the economics of pre-FID projects have fallen since 2016.