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James Stafford *Editor*

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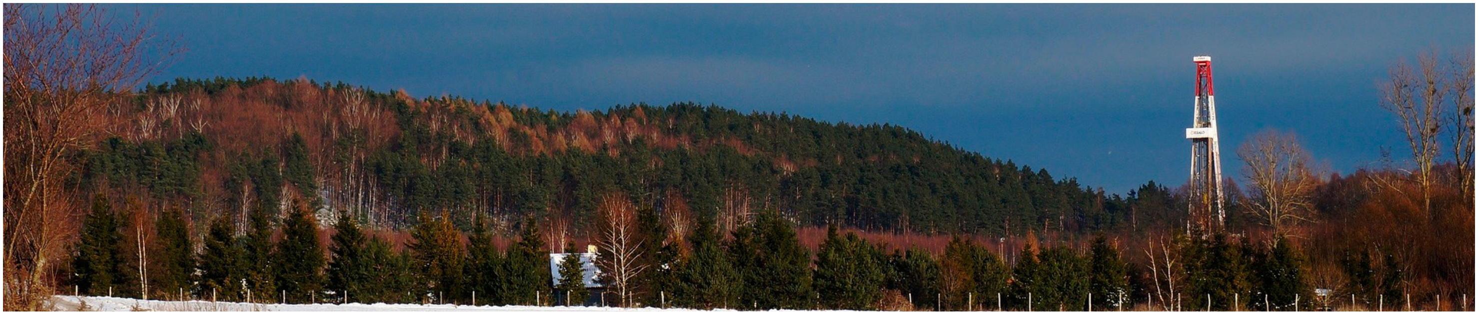


Oil & Gas Market Update

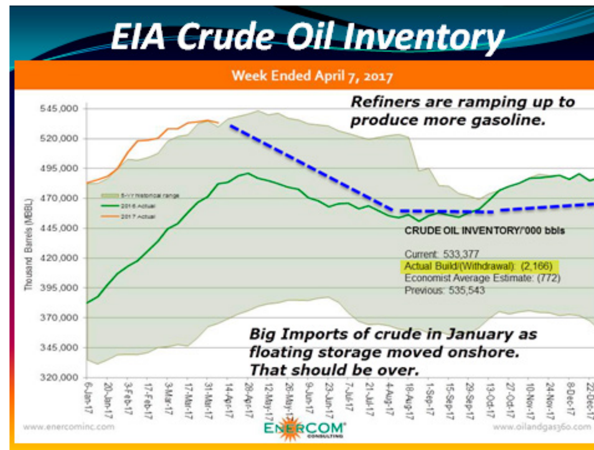
Outlook for the 2nd Quarter

The second quarter of 2017 should set the stage for a strong rebound for upstream oil & gas companies and oilfield services firms. We are going to find out in May if OPEC is serious about getting the global oil market back in balance and there should be a significant increase in demand for crude oil as we approach the summer driving season.

In the United States, the markets for natural gas and natural gas liquids ("NGLs") are much tighter than they were a year ago. We expect the prices of gas and NGLs to remain flat in the 2nd quarter and then ramp up during the second half of the year.

Crude Oil Prices

On April 12th the **Energy Information Administration ("EIA")** reported the first meaningful draw from United States' crude oil storage. U.S. refiners have completed their annual maintenance and are now ramping up the production of summer blend gasolines. By law, "summer blends" of gasoline must contain more crude oil. In the winter, refiners are allowed to blend in more low cost NGLs (primarily butane). This is the main reason that gasoline prices go up each year in April and May.



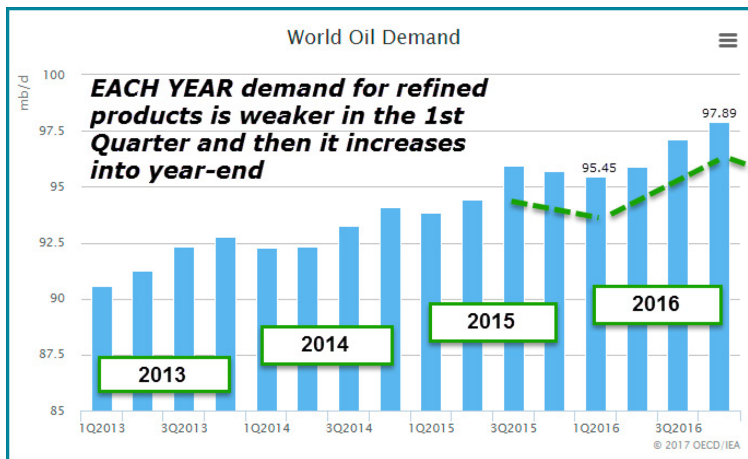
Refined product inventories in the United States have declined since peaking in February:

- Gasoline down 22.9 million barrels
- Distillate fuel oil down 20.5 million barrels
- Kerosene type jet fuel down 1.6 million barrels

Wall Street traders tend to over-react each week to the EIA crude oil storage report when it first comes out. It is important to look at total liquids inventories. They have been on steady decline since January and the rate of decline should accelerate in the 2nd quarter.

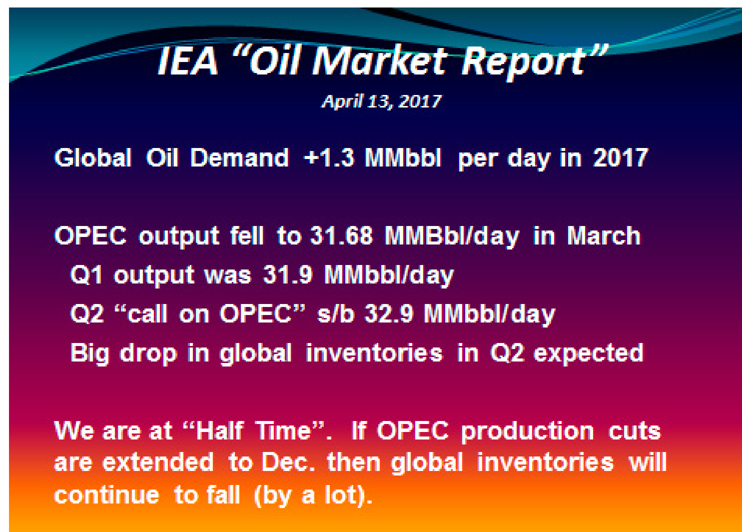
Demand for products refined from crude oil, primarily transportation fuels, is seasonal. The reason for this is that 90% of humans live in the northern hemisphere and more and more of them drive cars, SUVs and pickups each year. The seasonal demand difference is growing because fewer homes use oil for space heating and millions more vehicles hit the road each year. For example, in 2016 the global demand for refined products went from 95,450,000 million barrels per day in the first quarter to 97,890,000 in the fourth quarter. Most of the increase occurred from Q2 to Q3.

The **International Energy Agency based in Paris ("IEA")** published their monthly *Oil Market Report* on April 13$^{th.}$ The IEA is now forecasting that global demand for hydrocarbon based liquids, most of them refined from crude oil, will increase by 1.3 million barrels per day in 2017. As it does each year, most of the increased demand will occur May through September.



As you know by now, OPEC members and several other oil producing nations agreed to cut oil production by approximately 1.8 million barrels per day during the first half of 2017. The agreements were announced November 30, 2016 and went into effect on January 1, 2017.

The IEA reported that OPEC cartel members are now in full compliance with their agreement to cut 1.2 million barrels per day, with Saudi Arabia leading the way by actually cutting more production than required. The Russian led group that agreed to cut 588,000 barrels per day is estimated to be about half the way to their agreed cuts.



Helping OPEC reach their production targets were losses in Nigeria and Libya (both exempt from the agreement) due to unplanned supply disruptions.

"OPEC's 1Q17 output of 31.9 mb/d was 240,000 b/d below the 1Q17 "call" on its crude. The call on OPEC rises to 32.9 mb/d in 2Q17, which implies global stocks will draw further if OPEC maintains solid adherence to its supply cut." – IEA Oil Market Report summary 4/13/2017

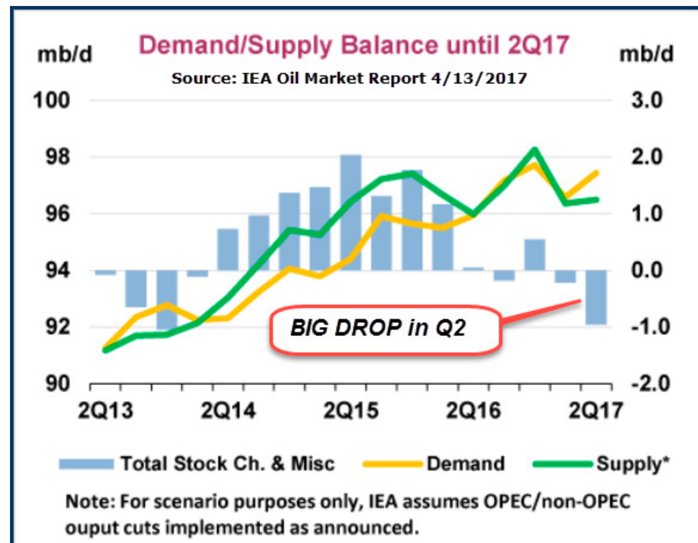
The "Big News" that will drive oil prices in 2017

At their May 25, 2017 meeting OPEC will officially announce if they are going to extend their agreement to limit production. Saudi Arabia has already said they think the agreement should be extended, but the OPEC cartel members are not the "best of friends", so the oil traders are being cautious. Obviously, it is in the interest of all the cartel's members to do whatever they can to increase oil prices. All of the OPEC nations must have oil prices higher than we have today to balance their budgets.

So far, the eleven OPEC members that agreed to make production cuts are "playing fair"; much more so than most analysts expected. Saudi Arabia has shown strong leadership and they have a lot of influence over the Gulf States. Oil prices have stabilized again recently after falling by about ten percent in early March, with recent unplanned outages and rising political tension in the Middle East playing a role. For OPEC countries, compliance has been impressive from the start while non-OPEC participants are gradually increasing their compliance rate, although in their case it is harder for analysts to verify the data.

"Even at this mid-way point, we can consider what comes next. It is of course OPEC's business to decide on its output levels, but a consequence of (hypothetically) extending their output cuts beyond the six-month mark would be bigger implied stock draws. This would provide further support to prices, which in turn would offer further encouragement to the U.S. shale oil sector and other producers." – IEA Oil Market Report summary 4/13/2017

Atlantic Basin refiners, primarily in the U.S. and Europe, are expected to increase demand for crude oil by 3.5 million barrels per day from March to July. That means we should see steady declines in U.S. and global crude oil inventories this quarter. If OPEC announces that they have agreed to stick with their production quotas in May, we forecast that the price of West Texas Intermediate ("WTI") will push through resistance at $55/Bbl and rapidly move to over $60/bbl.

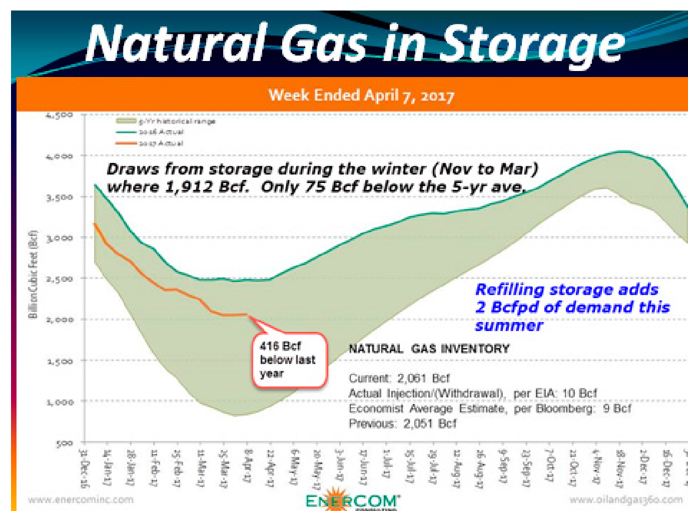


U.S. Natural Gas Prices

The United States natural gas and NGL markets are much tighter than they were a year ago. The *"El Nino"* winter of 2015-2016 left a much higher than normal amount of natural gas in U.S. storage at the end of March, 2016. The natural gas *"glut"* in North America drove the price of natural gas below $2.00/MMBtu early in 2016 and masked the tightening that was occurring outside of winter weather related supply/demand.

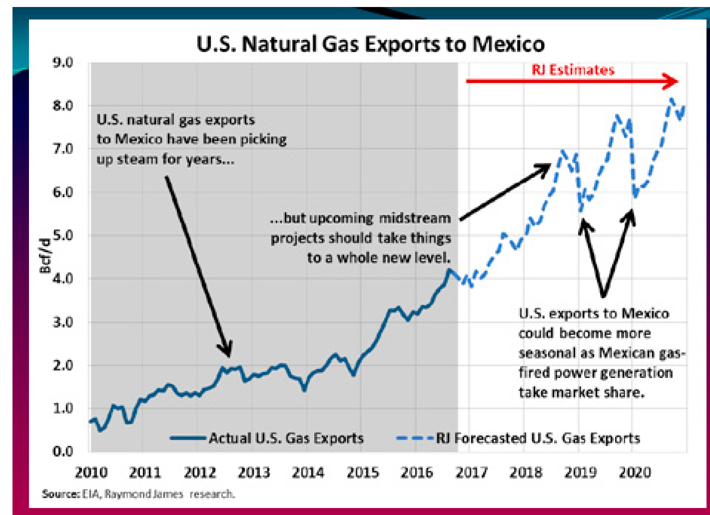
The U.S. winter of 2016-2017 started cold and ended cold, but it was much warmer than normal in January & February. Despite a slightly warmer than normal winter overall, U.S. gas in storage is now about 420 billion cubic feet ("BCF") lower than it was a year ago. This deficit will add approximately 2 BCF per day of additional demand during the storage refill season. Non-weather related demand is going up an additional 2.5 BCF per day in 2017 (per Simmons & Co. research report dated 01/12/2017) and U.S. gas production is down about 2.0 BCF per day from 2H 2015 to 2H 2016 (per the EIA database).

U.S. natural gas production is now on the rise and it is expected to be 0.8 BCF per day higher year-over-year in 2017. However, we see a tight U.S. natural gas market through 2018 that should keep gas prices in the $3.25 to $3.75 per MMBtu range. A hot summer followed by a cold start to next winter could push natural gas over $4.00 per MMBtu.



Cheniere Energy (LNG) is now expected to put Train #3 at Sabine Pass on-line in July. It will take approximately 2.5 billion cubic feet per day (Bcfpd) and liquefy it for export. Combining this step change in demand with increasing exports to Mexico and increasing demand for power generation leads to a very tight North American natural gas market heading into next winter's heating season.

"We continue to remain bullish on the summer outlook for natural gas. Recent data points continue to indicate tightening supply/demand fundamentals, providing further support to our natural gas price forecast of $3.40/MMBtu on average for the remainder of 2017, which is 9% above consensus estimates and highest on the Street. So despite the recent rally in natural gas prices, we believe the trade has additional room to run." – Wells Fargo Equity Research 4/12/2017



We are in a low demand period for natural gas right now, but we believe it will become clear to the market by the end of the 2nd quarter that it will be difficult to refill storage to adequate levels before the next winter heating season begins. We agree with Wells Fargo's analysis that natural gas prices *"have room to run"*.

Natural Gas Liquids prices have also improved and we expect them to average approximately 50% of the price of WTI by the 4th quarter. A rapidly growing U.S. petrochemical industry and exports are driving up demand.

NGL demand increased approximately 15% year-over-year in 2016. Most of the increase was attributable to higher exports, which account for approximately 30% of demand. 40% of demand was driven by the petrochemical industry, which uses NGLs as feedstock in steam crackers to produce ethylene and other products. 18% goes to gasoline blending and the remaining 13% is used for heating and fuel (primarily propane).

Petrochemical demand for light feeds (ethane, propane, and butane) remained high at approximately 94% of the overall steam cracker feed slate, above the five-year average of 90%. Many refineries have retooled existing facilities to accept additional NGL feedstock for blending with crude oil, given its relative cost advantage. Petrochemical demand is expected to increase steadily from mid-2017 through 2018 as several new facilities and expansion of existing facilities come on-line.

Higher U.S. ethane production has resulted in increased ethane exports both by pipeline to Canada and by tanker overseas. Both the 35,000 Bbl/day Marcus Hook terminal near Philadelphia, which will provide an outlet for Marcellus and Utica NGLs, and the 200,000 Bbl/day Morgan's Point terminal in Houston are the U.S's first ethane export terminals and will help U.S. gas producers such as **Range Resources (RRC)** find more favorable NGL pricing in international markets.

Conclusion

If you are an investor in oil & gas companies, including upstream, midstream and oilfield services companies, our advice is to "Hang Tough". During the second quarter we are going to see a tightening of the commodities markets, especially in the United States. In May, we should get the official announcement that OPEC is going to extend their agreement to limit production. Plus, we are already seeing a sharp increase in demand for crude oil by refiners as they come out of the annual maintenance period and ramp up production of transportation fuels.

All oil price cycles come to an end and this one appears to be deep in the 4th quarter.