ANALYSIS: Saudi production cut ‘gift’ to remain unopened by the US shale sector

Saudi Arabia will implement its unilateral crude production cut of an extra 1 million barrels/d from next week, with the move heralded as a “great New Year present” to the oil sector by Russia’s deputy prime minister Alexander Novak. Following Saudi’s announcement in early January some market observers suggested that the cuts will incentivise US shale producers to boost production, however a multitude of bearish factors persist which are expected to see a recovery in US shale production deferred until 2022.

Riyadh’s announcement on 5 January that it will voluntarily curtail production by an additional 1 million barrels/d in February and March sent shockwaves through the market – lifting the front-month Brent crude price to its highest since February 2020 and leaving many market observers scratching their heads as to why Saudi Arabia is initiating such a move.

Explaining the rationale behind Saudi Arabia’s production cuts, Chief Analyst at Renaissance Energy Advisors, and Research Associate, Oxford Institute for Energy Studies, Ahmed Mehdi told Gas Matters Today: “Despite media headlines suggesting it was a political move to appease the incoming Biden Presidency, this is not true.”

“Aramco had a very dour view of Q1’21 demand. Also, by reducing stocks [oil inventories], it gives Aramco greater flexibility to respond to the demand-side picture. The Saudis also realised that their valuable Asian refiner customers are undergoing maintenance,” added Mehdi.

Aramco’s apparent bleak crude demand outlook over the current quarter is playing out. Covid-19 cases are soaring globally, leading to fresh lockdowns in the likes of China – the world’s largest crude importer – which is seen as hitting oil demand.

Last week saw the International Energy Agency (IEA) revise its crude demand outlook lower on the back of growing Covid-19 cases. The Paris-based organisation expects oil demand to recover by 5.5 million barrels/d in 2021 to hit 96.6 million barrels/d – a figure 0.3 million barrels lower than its December assessment.

In addition to soaring Covid-19 cases, the leading manufacturers of the Covid-19 vaccines, Pfizer and AstraZeneca, are looking to cut supplies of their respective vaccines to the European Union. AstraZeneca, which is developing its vaccine with Oxford University and has yet to receive clearance for its jab from the EU, told Brussels last week that it will not be able to meet the Q1’21 supply target – a further bearish factor on oil demand.

On the other side of the Atlantic, the Biden administration is now in office and is planning to implement a reported USD 1.9 trillion stimulus package to help the US economy recovery from the pandemic. Oil prices have rallied on news of the Covid-19 recovery package, as the stimulus package is seen as driving oil demand. Norwegian consultancy Rystad Energy last week projected that the Biden administration’s recovery and infrastructure plans could lift the US’ oil

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products demand by ~350,000 barrels/d in 2021 to hit ~19.45 million barrels/d.

Whilst the US stimulus package has helped lift oil prices in recent days, the gains have been muted by the bearish demand side factors. US oil benchmark WTI remains just above USD 50/barrel – a level widely regarded as the break-even level for many US shale producers.

That said, last week saw US drillers add oil and gas rigs for a ninth week in a row. The rig count, which is viewed as an indicator for future output, hit 378 active rigs on Friday, up five compared to the previous week, according to Baker Hughes. The acive rig total is up from a record low of 244 in August 2020, however the count is still 416 rigs lower than the same period a year earlier – a sign that the US shale patch has some way to go before returning to pre-Covid-19 production levels.

“The rig count has gone up but I think there are too few new wells being added on a monthly basis to dramatically increase production (its more to offset legacy production),” said Mehdi.

“Overall, however, capex falls, tighter financing and the strong likelihood of further M&A this year will mean output likely reduces as operators use the price increase to remain capital disciplined and improve FCF [free cash flow] yields,” added Mehdi.

Another factor which could limit production gains in the US shale patch is potential frac sand shortages stemming from last year’s industry downturn, which saw sand miners go bust or face underinvestment.

“[S]ervice companies had a brutal 2020 but also the price crash forced frac sands companies to identify new ways to drive down costs (e.g., reducing truck distances or mining at well sites directly),” Mehdi said.

The US Energy Information Administration (EIA) has forecast for total US crude production to stand at 11.3 million barrels/d in 2021 – 0.2 million barrels/d less than 2020. However, a resurgence is expected to start from Q2’21, which will lead to production hitting 11.5 million barrels/d in 2022 – a figure still substantially below the 12.2 million barrels/d seen in 2019.

With the US shale patch not expected to seize on the Saudi cuts, the focus turns to who emerges as the ‘winner’ from the Saudi’s move. Mehdi suggests Riyadh will emerged victorious from its self-imposed cuts as “it now has greater flexibility to navigate the demand uncertainty by reducing the high inventories”.

“Also, it keeps the market guessing on its next move,” Mehdi concludes. – ET

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