ARAB OIL & GAS

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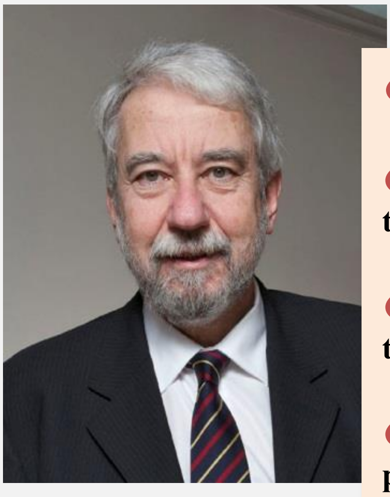
57 rue d'Amsterdam | 75008 Paris | France

www.stratener.com
fperrin@stratener.com
+33 (0) 6 63 68 79 03

INTERVIEW

Olivier Appert,
President of the French Committee of the World Energy Council

"The continuing decline in oil prices is probably behind us …"



- **The conditions of a production stabilization are not met**
- **For Saudi Arabia, the Sunni Arab solidarity is more important than solidarity between OPEC member countries**
- **The return of Iran on the oil market is an inescapable fact but this should take time**
- **The reduction in capital expenditures since 2014 could lead to a production shortfall of 4 million b/d by the end of the decade**

Hereinafter the text of an interview with Mr. Olivier Appert, president of the French Committee of the World Energy Council and General Delegate of the French Academy of Engineering. See page 5 for more details.

Arab Oil & Gas (AOG): Oil prices rebounded since mid-February and exceed $40 per barrel currently. Can this rise be sustainable?

Olivier Appert: Various factors contributed to the recovery in oil prices in recent weeks: a drop in oil production outside OPEC and a falling dollar. But above all, the market, which played lower prices for months, reacted to the signal launched in Doha by Saudi Arabia, Russia, Venezuela and Qatar in favor of a stabilization of production. Although no concrete action has been taken further to this statement to date, speculative investors have changed their positions. The continued decline in prices is probably behind us. This does not mean that prices will continue to rebound. As stated by the International Energy Agency (IEA) with great caution, we begin to see "light at the end of the tunnel."

AOG: Can OPEC and non-OPEC producers agree in 2016 on supply reduction?

O. A. : The Doha agreement specified that the signatories agreed to stabilize their production provided that other producers do the same. The day after Iran said clearly that there was no question for it to stabilize production while the end of the embargo opened it the opportunity to regain its lost market share. The conditions of an agreement on production stabilization are not met in particular for geopolitical reasons. It is doubtful that this may change in the course of the year.

Let us remember the statement by the Saudi Oil Minister, Ali Al-Naimi, on the sidelines of the OPEC meeting in November 2014: "if OPEC cuts production, that is to say in fact Saudi Arabia, other producers will take the opportunity to seize market share, Brazil, Russia and the LTO producers (light tight oil) in the U.S.". So far Saudi Arabia has not changed its policy of defense of its market share as it did in 1986 during the oil counter-shock. Al Naimi has reconfirmed its position at the recent CERA Week conference in Houston. The Saudi intervention in Yemen shows clearly that, for the country, the Sunni Arab solidarity is more important than solidarity among OPEC countries. The recent breakdown of diplomatic relations between Saudi Arabia and Iran makes it unlikely that an agreement will be concluded among leading players in the short-term.

AOG: Is the excess of global oil supply over demand of the order of 2 million barrels per day?

O. A. : Demand continues to grow in 2016 but at a slower pace in 2015. This is especially due to China whose demand growth in 2016 should be only 0.3 million barrels per day (Mb/d), or half as much as last year. Supply is expected to continue to grow albeit at a lower rate than in previous years: +0.7 Mb/d as against 2.4 Mb/d between 2014 and 2015. It implies an oversupply in 2016 estimated at 1.6 Mb/d. The market is beginning to rebalance, but it remains in surplus: this surplus decreases in the course of the year from 2.2 Mb/d in the second quarter of 2016 to 1.2 Mb/d in the fourth quarter.

However, a controversy swells today on the "missing barrels", as was the case in 1998: in fact the IEA's supply/demand statistics show a gap of 0.8 Mb/d, but there is debate among the specialists about the reasons. This may be due to a statistical bias on supply, demand and stocks in non-OECD countries. But basically, today as in 1998, the market is perhaps a little more tense than estimated but it nevertheless remains that it is oversupplied.

AOG: Can the market return to a relative balance in 2017?

O. A.: The market is gradually rebalancing itself but at a slower pace than anticipated. Lower prices boost demand: thus, in the United States, there is a boom in sales of SUVs. OECD consumption is stable but non-OPEC demand, boosted by the emerging countries, increases even if the growth rate is lower than in recent years.

On the supply side, the resilience of shale oil in the U.S. surprised everyone. But production begins to decline. In 2016, LTO production should return to its 2014 level.

Oil companies have responded to falling prices by drastically reducing their investments. However, they continue to produce their conventional resources at the maximum as far as the market price is higher than the operating costs (excluding investment), which is the case with most of the conventional production. Eventually, however, their production should decrease to the extent that the natural depletion of the fields will not be offset by new developments. It is estimated that the reduction of investments for 2014 will result in a production shortfall of 4 Mb/d at the end of the decade.

Thus the market is gradually rebalancing. At low prices of previous episodes, the market was rebalanced in about four years. This may be longer today.

Moreover we must not forget the geopolitical dimension of the oil market. One cannot exclude diplomatic-military contingencies in the Middle East that reshuffle the cards. Today's available production capacity ("spare capacity") is limited: it would be difficult to deal with a supply disruption of a producing country as we noted at the beginning of this decade.

AOG: How to explain the strong resistance to the falling prices of unconventional production in the United States?

O. A.: All the experts were wrong about the costs of production of LTO in the United States. Four years ago they were estimated within a range of $60 to $90/b. Despite a fall by two-thirds of the number of active drilling rigs in the U.S., production fell only slightly. U.S. operators have demonstrated remarkable responsiveness to industrialize the production process, reduce costs and increase productivity. Thus the cost of LTO drilling has been reduced by a factor of 2 in five years. The depletion of fields is always rapid but the maximum well production has increased by 10 since 2007. The rig productivity has increased on average by 37% a year and even 80% for the Permian Basin.
Other reasons have been put forward: a part of the production was the subject of financial hedges, many wells have been drilled but not put into production, very attractive financing terms have been established...

However, price pressure is becoming stronger. Companies are struggling to repay their debts and this issue is very important because financial leverage is high. To date, more than 40 U.S. operators are in receivership (Chapter 11).

AOG: Is Saudi Arabia winning its bet?

O. A.: In 2014, Saudi Arabia led the same policy than in 1985. It decided to defend its market share at the expense of the price level. Its production costs are among the lowest and the country controls very important financial resources accumulated in recent years. Saudi Arabia can therefore bear the consequences of lower prices until the market rebalances itself by the end of the decade. This is not the case for many OPEC countries and oil companies. Under these conditions, the bet of Saudi Arabia can be won.

AOG: Iran obtained a partial lifting of international sanctions in January 2016 and intends to come back strongly on the oil market. Is this expectation wishful thinking?

O. A. : The oil embargo led to a decline in Iranian oil production of about 1 Mb/d. The leaders of this country have shown their willingness to return to the market at the earliest. We must remember that the lifting of the embargo is not complete yet. In addition the agreement provides for the reestablishment of the sanctions in case of subsequent breach of Iran's obligations (known as "snap-back" mechanism). It is true that the agreement specifies that, in such a case, the sanctions should not have any retroactive effect but the fact remains that this provision places a sword of Damocles over the long-term investments that could be decided by companies. It is also necessary to put the Iranian banking system, which is in a poor condition, back on track.

When the sanctions will actually be lifted, the country will have access to international financing and technology which were missing for 40 years. The first priority is to upgrade Iran's oil and gas industry which suffered from a lack of investment for years.

The increase in Iranian oil exports will come first through the sale on the market of existing stocks and the increase in the production of already exploited fields. In the longer term, it will come from the start-up of new fields and the investment of international oil companies. But all this will take time.

The mobilization of existing stocks could lead to an immediate increase in exports of about 200,000 b/d. At least six months will be needed to increase production from existing fields by about 500 000 b/d. The contribution of new developments should take about two to three years.

The return of Iran on the oil market is an inescapable fact: but it should take time.

AOG: Is an oil price of around $100/b or more really behind us?

O. A.: When the market will be rebalanced, Saudi Arabia will regain market power. But U.S. producers of unconventional oil, at least those which will survive, retain the ability to quickly return to the market as and when oil prices recover. This will implicitly result in a cap on medium-term oil prices. It is also necessary that the LTO resources in the United States are large enough to sustain production growth: on this point, we can note the prudence of the U.S. administration on the LTO production outlook for the next decade. This suggests that prices of $100/b are probably not relevant for the next decade. But that's without taking into account the impact of the oil market on a possible destabilization of the Middle East ...

CURRICULUM VITAE

OLIVIER APPERT

From 2003 to 2015, Mr. Appert has been Chairman and CEO of IFP Energies nouvelles (IFPEN). He is chairing the Conseil Français de l'Energie, French committee of the World Energy Council. He is General Delegate of the French Academy of Engineering.

Prior to that, in October 1999, he was appointed Director of the International Energy Agency's Long-Term Cooperation and Policy Analysis Directorate. From 1998 to 1999, he was the Senior Executive Vice-President of ISIS, a technology holding company publicly listed subsidiary of the Institut Français du Pétrole (IFP). From 1994 to 1998 he worked as Executive Vice-President of the IFP in charge of research and development activities. From 1989 to 1994, he headed the oil and gas department of the French Industry Ministry. Mr. Appert also served in the private sector from 1986 to 1989 as Vice-President of the Phillips group for mobile radio activity and strategy. He was Executive Director of the French Industry Minister's cabinet from 1984 to 1986 and was a member of Prime Minister's cabinet from 1981 to 1984.

Mr. Appert is a graduate of the Ecole Polytechnique and Ecole des Mines.