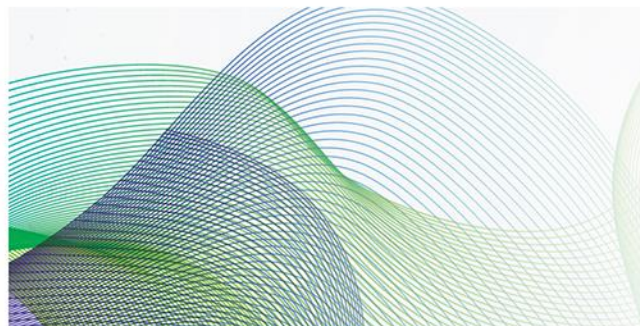


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OPEC at the Crossroads

Executive Summary

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As the OPEC oil ministers prepare to meet for their semi-annual Ordinary Meeting on June 22nd, they are faced with some difficult choices. On the one hand, by extending the output cutbacks amidst higher risk of output disruptions, OPEC risks overtightening the oil market, pushing oil prices higher and leading to an inevitable demand response. Moreover, involuntary cuts originating mainly from Venezuela, Angola and Mexico that alone amounted at 0.92 mb/d as of April 2018 in excess of their pledged targets, mean that the oil market is tightening more quickly than anticipated. On the other hand, by exiting the agreement too early OPEC runs the risk of prices falling if such a decision is not supported by favourable market conditions especially as 'the clouds over global economy are getting darker by the day', while it endangers dismantling a historic coalition of OPEC/NOPEC producers which took massive diplomatic effort to put together and whose coordination proved critical for the rebalancing effort.

In this Energy Insight, we consider the hard realities of oil market and price dynamics for 2018 and 2019 to draw, analyse and assess the most prevailing oil output policy scenarios that are likely to drive the discussion during the upcoming OPEC Ministerial Meeting, through the lens of a structural VAR model of the global oil market. The study does not take a stance on what will be the outcome of the June 22nd OPEC Meeting, but rather it attempts to quantify and evaluate the risks associated with each policy scenario in terms of the impact on oil prices and global demand growth for the remainder of 2018 and 2019.

A cursory view of the key oil market indicators reveals that since OPEC last met in November 2017, the oil market has tightened and oil prices have been on an upward trajectory. Our results show that the robust growth of global oil demand has been the main contributor to the price increase, adding over \$9/b (*flow demand*). Geopolitical disruptions (*exogenous supply*) added a further \$2/b, while the continued strong OPEC+ compliance to the output cutbacks offset by gains in the US and Canadian production had a net neutral contribution to the price increase of less than \$1/b (*endogenous supply*). There is no indication that *speculative demand* pressures contributed to the price rise, rather instead, the release of stocks has helped ease the hike by about \$3/b.

Also there has been a general deterioration of the geopolitical environment. In a rising market characterised by declining stocks and low availability of spare capacity, the ability of the oil market to absorb any unexpected disruptions in supply (or demand for that matter) is limited, and therefore concerns about the future availability of oil supplies put significant upward pressure on oil prices. Although the threat from the US sanctions to Iranian output is highly uncertain and the potential price implications are not likely to be felt in 2018, this episode remains important for forming price expectations in 2019. Our results show that if the renewed US sanctions were to result in the same size of losses in Iranian production as those occurred by the sanctions in 2012, the impact on oil prices under current market conditions would be twice as large as in 2012. Indicatively, within a year, the oil price increases by as much as \$21/b, all else remaining equal, compared to the actual impact of about \$10/b experienced back in 2012. Thus, although most estimates regarding the size of the



potential losses of Iranian exports lie close to a third of the 1.4 mb/d decline caused by the sanctions in 2012, this does not eliminate the risk of sharp price rises.

Looking ahead into the rest of 2018 and 2019, we build a *reference scenario* which depicts to the best of our knowledge how the underlying supply and demand dynamics are expected to unfold through 2018 and 2019, conditional that the OPEC oil output policy remains unchanged for the entire period (this scenario may also be interpreted as OPEC deciding to extend the current agreement of output cutbacks). Our reference forecast projects oil price gains in the second-half of 2018 and sustaining that momentum well into 2019. In 2018, the average annual Brent price is expected to increase to \$75/b or 35% higher than 2017, followed by a further annual increase of about \$4/b in 2019 (\$79/b) and ending the year at \$81/b. These results suggest that OPEC is now faced with a reality of oil prices hovering around \$80/b in the near-term, which might be good news for the producers in the short-run (e.g. by boosting their revenues), but they could prove damaging in the long-run by prompting a demand response as well as encouraging new supplies entering the market.

We then assess three principal scenarios reflecting the prevailing options facing OPEC+ and in particular the core GCC producers (Saudi Arabia, UAE and Kuwait) and Russia:

The *all-in-one-go scenario*, according to which the OPEC+ oil producers exit the deal in July 2018, releasing all 1.0 mb/d of crude currently held under the agreement back into the market;

The *gradual scenario*, according to which the OPEC+ oil producers exit the deal gradually, lifting their production by 0.5 mb/d in July 2018 and releasing the rest in January 2019;

The *cautious scenario*, according to which the OPEC+ oil producers increase their production by 0.5 mb/d in July 2018, while retaining their flexibility to reassess the prevailing market conditions in November 2018 before committing to any further increases.

We find that if OPEC chooses the *all-in-one-go* option, the oil price will decline by \$10/b within six months and fall below \$70/b by the end of 2018. In 2019, the oil price is expected to oscillate within the \$60/b range for most of the year, before recovering again back to \$70/b as lower spare capacity starting putting upward pressure on the oil price. In the case that OPEC chooses to increase its production by the same amount but to do it *gradually*, the impact on prices in 2018 will be halved relative to the all-in-one-go option, but as we progress in 2019 the two scenarios converge as expected. Lastly, adopting a *cautious* approach will help the producers keep a solid floor on the oil price at \$70/b for both 2018 and 2019, while eliminating all of the upside potential in the latter period compared to the reference forecast. This means that while there is strong evidence suggesting that an output increase to ease balances in 2018 might be in order, committing to any further adjustment actions for 2019 at this stage could prove premature.

We then assess the risks inherent in the projected growth of global oil demand under the alternative OPEC+ oil output policy options. Our results show that that regardless of the outcome of the upcoming OPEC meeting, the growth of global oil demand in 2019 is set to ease to about 0.2% to 0.4% lower than in 2018. Having said that, the potential of an OPEC+ output increase could counter that drop by as much as 0.3 percentage points. Thus, the size of the output adjustment does matter and particularly in the long run. In other words, for OPEC, the future oil demand growth (especially in 2019) hinges heavily on the outcome of its upcoming meeting, just as the success of its oil output policy hinges heavily on the prospects of global oil demand remaining healthy.

In short, OPEC members and particularly its dominant player Saudi Arabia are facing some hard choices. The decision for members that have the capacity to increase production is not only whether to increase or not to increase output, but also by how much to increase production and whether to do it in a gradual manner. Another key decision that the key members of the OPEC+ coalition (mainly Saudi Arabia and its Gulf allies and Russia) have to face is whether they would increase output within the current framework of cooperation. Regarding the first decision, our results call for a cautious approach in which OPEC increases output gradually and reassess their options in November as this will help keep a solid floor on the oil price, which remains a key objective for all producers. Increasing output by around 1 million b/d in the current context could result in a sharp fall in the oil price and



affect negatively market sentiment. Also, the impact of such a move may be short-lived as increasing production reduces the level of spare capacity in the system keeping the upward pressure on the oil price, especially given that stocks have already fallen.

We also argue how OPEC decides to implement the output increase also matters. If the decision is to increase output, then it is in the interest of OPEC+ to reach a collective decision. However, in the current context, this may prove difficult, as producers who don't have the capacity to increase production and those who are subject to US sanctions will resist such a recommendation. If it is not possible to reach a collective agreement on increasing output, the producers who have the capacity, and who could really influence market outcome are then faced with three options: either to extend the current agreement of output cuts in order to maintain the cohesiveness of the coalition and risk the impact of higher oil prices on demand; exit the deal altogether and announce that they would increase their output regardless of the actions of other producers, bringing to an end the framework of cooperation; not to dismantle the OPEC+ deal in the next meeting and to postpone the difficult negotiations until November, while still going ahead and increasing output individually.

While the last two options are not very different in terms of their impact on market balances, the choice of exit will affect sentiment and prices at least in the short-term. This shows the balancing role that OPEC has to play and the importance the key players should attach to retaining their flexibility. Sending a strong and clear signal may not always be the best option for OPEC. Some constructive ambiguity where producers with capacity to increase production show strong willingness to act on the upside without committing to a specific number or timing may be the preferred option in this current context.