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Saudi-Russia Production Accord:
The Freeze before the Thaw?

OXFORD ENERGY COMMENT

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Introduction

The accord reached by Saudi Arabia and Russia, along with Qatar and Venezuela, in Doha on February 16th has been widely seen as effectively an agreement to do nothing.[1] The four countries have accepted a freeze in production based on January 2016 levels, but for most of them (with the exception of Saudi Arabia) this effectively means the ability to maintain oil output at or near full capacity. The impact on the oil market balance will be minimal, especially in the short term. Furthermore, significant caveats were included in the Doha agreement, in particular that it would only take effect if other OPEC and non-OPEC countries agree to co-operate. Saudi oil minister Al-Naimi also added that his country would 'continue to satisfy customer demand' for oil. Indeed, the reaction of the oil market, which saw prices rise by more than 10% in anticipation of the meeting but then fall back by over half that amount after its conclusion, underlined the ostensibly disappointing outcome.[2]

However, despite the minimal impact of the deal on market balances, the reaching of an accord between the largest OPEC and non-OPEC producers does suggest some interesting conclusions for the oil market over the next few months, as subtle shifts in negotiating tactics have started to emerge. In this light, it is valuable to consider the current positions of the leading players and their potential roles ahead of the much anticipated OPEC meeting scheduled for June 2nd.[3]

What were the catalysts for the deal, and what are the positions of the leading players?

The Saudi perspective:

From a Saudi perspective the accord with Russia has allowed it to respond to the increasing pressure it had come under from fellow producers to take some control of the oil market. In particular Venezuela, whose economy and oil industry has been put under severe pressure by the collapse in prices, has led the attempts to reach an OPEC agreement, but many other member countries have also expressed an interest in re-establishing order to the oil market.[4] Saudi Arabia itself is in a more robust position with around $600 billion of foreign currency reserves and low levels of debt,[5] but the Saudi budget has also come under pressure from lower oil prices given that the economy remains highly reliant on oil revenues despite continuous efforts to diversify.[6] As a result, although it seems that the Saudis did not initiate the agreement to freeze production, which appears to have been formulated by the Venezuelan and Russian delegations, they nevertheless were keen to take an opportunity with limited downside for themselves to provide an indication to the market that proactive steps are being taken by producers.

Indeed, there are a number of reasons why Saudi Arabia might be keen to adopt an output freeze strategy at the present time. Firstly, non-OPEC production is likely to fall in 2016, with the IEA predicting a 0.6 million b/d decline in its latest Oil Market Report,[7] the largest decline in more than two decades. As a result, it makes sense for Saudi Arabia to encourage OPEC production restraint in order to accelerate the re-balancing of the oil market, as oil demand is expected to rise by more than 1 million b/d this year[8] and OPEC remains the biggest source of uncertainty on the supply side for 2016. The main stumbling block to this plan is the potential for a sharp increase in Iranian production, but in effect this issue has now been handed to the Iranian authorities, as they must now decide whether to go along with the agreement or not.

[1] For example, Bloomberg, 16 Feb 2016, 'Saudi Arabia, Russia to freeze oil output near record levels'
[2] Oil price sourced at http://markets.ft.com/data/commodities/tearsheet/summary?c=Brent%20Crude%20Oil.
[3] http://www.opec.org/opec_web/en/311.htm
[4] Wall Street Journal, 12 Jan 2016, 'Some OPEC members want urgent meeting, says Nigeria'
[5] Figure from IMF at https://www.imf.org/external/np/sta/ir/IRProcessWeb/data/sau/eng/cursau.htm
[6] For example, CNBC, 3 Dec 2015, 'Saudi Arabia's big welfare spending faces the oil abyss'
[7] https://www.iea.org/oilmarketreport/omrpublic/
[8] Ibid.

Secondly, an agreement to freeze, rather than cut, production at this stage allows Saudi Arabia to test the resolve of all OPEC members, not just Iran. Saudi oil policy has always been that it refuses to act unilaterally, and this latest deal is caveated in the same way. As emphasized by Al-Naimi, this is 'not like cutting production, that's not going to happen' adding that 'not many countries are going to deliver' even if they promise production cuts.[9] The 'freeze deal' should provide a relatively easy test of OPEC's ability to compromise, as no country is being asked to cut output and most are producing at or close to capacity at present. As a result, the ability of OPEC members to comply with the very unchallenging terms of the current proposal will provide a clear indication of whether there might be any hope of imposing a tougher deal to cut output later in the year, should that be required.

Finally, the accord does provide clear evidence to the oil market that Saudi Arabia is prepared to take some responsibility for managing the supply balance once again, following a period when it has effectively abrogated all authority to the market. Although this first step is hardly a major one, as discussed above, it is nevertheless a step. Even the most sceptical commentators on OPEC's ability to act in a co-ordinated fashion to influence oil markets must acknowledge that the likelihood of Saudi action to reduce supply, should it be required, has increased, albeit from a low base.[10]

An additional point is that all this has been achieved at very low cost to Saudi Arabia. The only question mark could concern a possible loss of credibility over the maintenance of Saudi oil policy.[11] But as has been argued by Fattouh and Sen (2015) 'Saudi Arabia's conduct is not constant and tends to vary over time; it is therefore premature to exclude the possibility of a reversal in policy if market conditions change or other players show willingness to cooperate on an output cut.' Indeed, the Saudi authorities have stuck firmly to their stance that all OPEC members must co-operate if the proposed deal is to work, showing no sign as yet of a significant retreat from their earlier policy. Furthermore, the fact that Saudi Arabia will freeze its output at close to full capacity again indicates that its original strategy of waiting for higher cost producers to reduce production first is still very much in place[12], and also underlines that it continues to take a relatively a strong position ahead of future negotiations with its OPEC partners.

The Russian Perspective:

As we argued in a recent paper,[13] Russia has a clear economic motive to try to catalyse a rebalancing of the global oil market and a recovery in the oil price. Its economy is expected to show negative GDP growth for a second consecutive year in 2016, the federal budget deficit is likely to be more than 4% of GDP at current oil prices at a time when international finance has been restricted by sanctions[14] and the country's Reserve Fund (for use in times of low oil prices) is set to run out by the end of the year. However, senior ministers and oil company executives (in particular Igor Sechin, the CEO of Rosneft) have consistently refuted the need for Russia to cut production, and indeed have cited operational and governance reasons why it would not be practical.

As a result, an agreement to freeze output was likely to be the most that the Russian authorities could agree to at this initial stage. However, the fact that the proposed deal mandates a freeze at January 2016 production levels, when Russian output was at a post-Soviet high of 10.88 million b/d, has meant that it has been very easy for the country's energy authorities and its oil companies to accept. Essentially, if Russia can maintain the 2016 level for the entire year it will imply a 1.5% increase over the average 2015 level, but as Figure 2 shows, the January production level tends to be a high for the first six months of the year. This is due to the better operating conditions in West Siberia during the

[9] Bloomberg, 'Saudi Arabia Won't Cut Crude Output, Oil Minister Al-Naimi Says' 23 February 2016.

[10] For instance, in a recent report, Credit Suisse argues that 'all else being equal, Doha reduces the risk that Saudi oil production rises a whole lot more in the near term, which reduces one of the two key bearish risks to our forecast, 2016 re-balancing (the other is a global recession)'.

[11] Al-Naimi reiterated his position in a recent speech arguing that 'high-cost producers will have to "lower costs, borrow or liquidate' in the high cost environment as this is 'more efficient' way of rebalancing than implementing cuts by low-cost producers'.

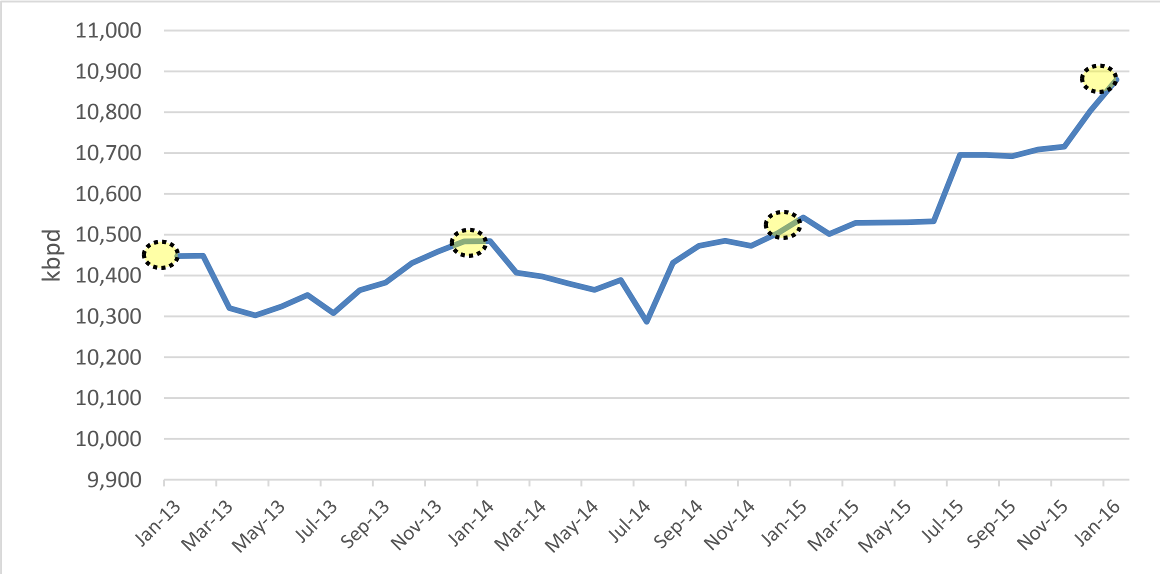
[12] Interfax, 19 Feb 2016, 'Russian budget deficit could exceed 4% of GDP if oil stays at current levels – MinFin'

[13] Henderson, J. & Fattouh, B. (2016), 'Russia and OPEC: Uneasy Partners', Oxford Energy Comment, Oxford Institute for Energy Studies

[14] Interfax, 19 Feb 2016, 'Russian budget deficit could exceed 4% of GDP if oil stays at current levels – MinFin'

winter when the ground is frozen and movement of equipment and personnel is easier than in the summer months, when huge lakes and marshes appear. As a result, it would not be a surprise if Russian output fell from the January levels, at least in the next few months, offering the government the opportunity to show how co-operative it is being, although in fact exports of crude oil may well continue to rise.

Figure 1: Russian oil production by month, 2013-2016 (January output highlighted)



Source: Argus Media

Indeed, it needs to be emphasized that the link between production and exports is very relevant in the assessment of Russia's position, as the two are not directly linked. In 2015 Russian oil production rose by 1.4% while exports to non-FSU countries increased by 10.6%[15] as a change in the tax regime encouraged vertically integrated companies to prioritise exports of crude oil over oil products (especially fuel oil).[16] This trend is likely to continue in 2016 as the same tax regime remains in place, meaning that even if Russia did freeze production at the January 2016 level, or even production falls slightly, this would not necessarily imply a fall in crude exports, especially at a time when domestic demand is being impacted by economic decline. Falling oil prices have also put Russian oil refiners under heavy pressure. Export duties and the cost of rail shipping are increasingly eating up the bulk of the revenue from fuel oil exports. The poor margin environment is accelerating the decline in Russian refinery runs, freeing crude for exports. Thus, even if Russia freezes output, exports can still rise.

As such, although Russia has certainly demonstrated its willingness to co-operate with OPEC in establishing a production ceiling, it has done so at a level which is hardly a challenge to its productivity. Indeed, the Energy Ministry had previously forecast that 2016 output would be flat compared to 2015, suggesting that this new agreement implies an uplift in expectations. In common with Saudi Arabia, then, Russia has established a relatively extreme starting point for any future negotiations on further action that may be needed to balance the market.

The position of other OPEC members

With Saudi Arabia, Russia, Qatar and Venezuela all agreeing to freeze production, but from a high level, it is perhaps not surprising that other OPEC members should take a similar line by establishing a high (and perhaps deliberately inflated) January 2016 output figure as a basis for any discussions. For example Iraq, whose production has leapt from 2 million b/d in 2010 to a high of over 4 million b/d

[15] Interfax, 2 Jan 2016, 'Russia's oil export to far abroad countries up 10.6% in 2015 to 220.267 tonnes'
[16] Henderson J. (2015) 'Key determinants for the future of Russian oil production and exports', Working Paper WPM 58, Oxford Institute for Energy Studies

in 2015, acknowledged the benefits of an agreement to freeze output, but only if 'all producers really want to cooperate.' It has then proceeded to set the starting point for its own potential compliance very high, by asserting that its production in January was 4.775 million b/d, a number that many observers regard as extraordinarily unrealistic. Indeed it compares with an IEA estimate of Iraq's production in December 2015 of 4.26 million b/d and a federal government number which was even lower than this at 4.125 million b/d, while it is a staggering 1.03 million b/d higher than the quoted November 2015 figure. It should be acknowledged that previous figures announced by the federal government did not capture all of Kurdish production, but even so it would now appear that these are being double or triple counted by the Iraqi authorities. Furthermore combined exports from north and south Iraq in January were 80,000 b/d lower than the November level, further undermining claims of a production boost. What is more likely is that Iraq believes it can achieve a figure of 4.775 million b/d during 2016, and has therefore claimed this as its January output level in order to allow it to reach its target in a production freeze scenario. However, in reality this exaggerated claim should also most likely be seen as a starting point for negotiation rather than a likely outcome should a formal agreement come into place.

The same tactic appears to have been adopted by Kuwait, which has indicated its willingness to participate in the production accord but which has long held a target to establish oil output of 3 million b/d in 2016, well above the 2.79 million b/d which the IEA shows that it produced in December 2015. An average of third party estimates suggests that the January figure was in fact closer to 2.85 million b/d, suggesting again an exaggerated claim in order to allow Kuwait to increase output in the second half of 2016 in pursuit of its stated objective of making up for lost Neutral Zone volumes. A consistent theme is therefore emerging, with countries setting out their most radical bargaining position in case they need to offer concessions in a future agreement to restrain output.

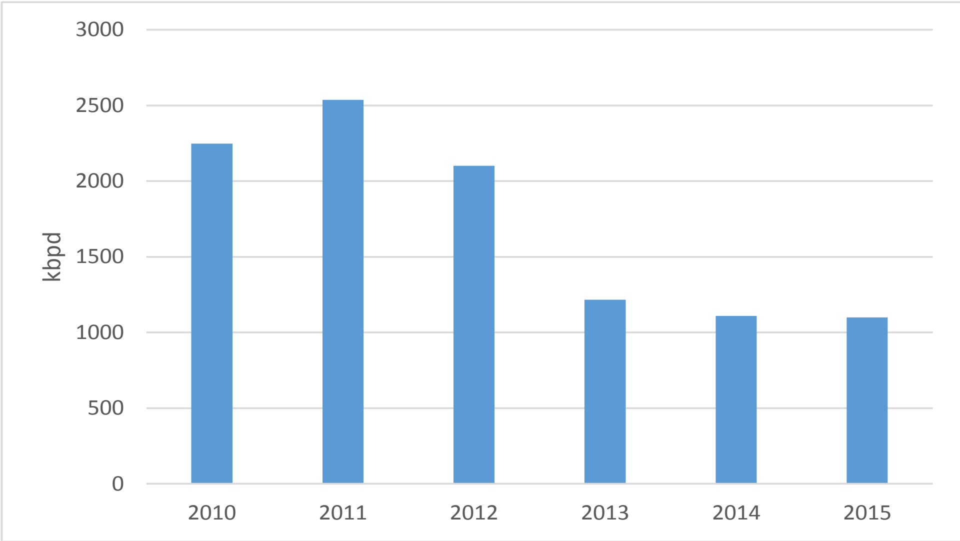
The exceptions to this 'exaggerate to negotiate' tactic are countries where unique circumstances have led to a recent decline in production and which have a goal to re-capture lost market share. One example would be Libya, which also supports the output freeze proposal but wants to be able to increase its production if the disruptions caused by recent political and security chaos ease. The country's output has fallen from 1.65 million b/d in 2010[17] to only 380,000 b/d in December 2015,[18] and so it is perhaps not surprising that the government is keen not to commit to freezing production at or close to this level in case an opportunity occurs for a rebound which could provide vital extra revenues for the country.

Iran's position as sanctions are lifted

If Libya's hope of recovering its lost market share is a rather slim one, at least in the short term, then the case of Iran is rather different as it has a clear ambition to raise output significantly in 2016 following the removal of sanctions. Since the imposition of sanctions in mid-2011, Iranian oil exports have fallen by more than 1 million b/d (see Figure 3 below), and so it is not surprising that the Iranian government has now set itself a target to recover its lost volumes, and expects its fellow OPEC members to make space for it in the market. Initial statements have asserted that production and exports will increase by 500,000 b/d in the coming months, with a target to recover 1 million b/d by the end of 2016. Although this latter target may be rather optimistic, it is clear that any form of production or export freeze at January 2016 levels is not in Iran's interest and completely contradicts its stated policy.

[17] BP Statistical Review of World Energy 2015
[18] IEA Oil Market Report, January 2016, Table 3

Figure 2: Iranian oil exports since 2010



Source: OPEC Statistical Bulletin

Consequently Iran has been placed in a difficult position by the Saudi-Russian agreement. However, it would appear that its oil minister, Bijan Zanganeh, has achieved the remarkable feat of providing positive news for the oil market without conceding that Iran will comply with the agreement to freeze production. Despite being put under significant pressure by the arrival in Tehran of the oil ministers from Qatar and Venezuela (the latter arriving as part of his tour of almost every major producer in the world in a desperate attempt to shore up the oil price), Zanganeh managed to offer his support without committing Iran to anything. Indeed his statement that 'the proposed production ceiling should be the first step towards stabilizing the market' managed to achieve what the actual Saudi-Russia agreement did not, namely a 7% jump in the oil price.[19]

Furthermore, despite the fact that he also added that 'our situation is totally different to those countries that have been producing at high levels for the past few years' and that 'Iran will not overlook its quota',[20] effectively refuting the idea that Iran would join a production freeze, Zanganeh achieved the best outcome he could have hoped for. Iran had little incentive to come out and reject the deal and, as a result, send prices spiraling lower. Equally it has no reason to join an output freeze which would effectively keep Iranian production at broadly pre-sanction levels of 2.8 million b/d, as for all the talk of a 0.4 million b/d increase since the sanctions were lifted in mid-January, it has so far barely managed to raise production by 0.1 million b/d. As a result, the Iranian oil minister has encouraged the oil market to believe that Iran will not overtly obstruct a deal, but has emphasized that in any further negotiations it also has a strong opening negotiating position.

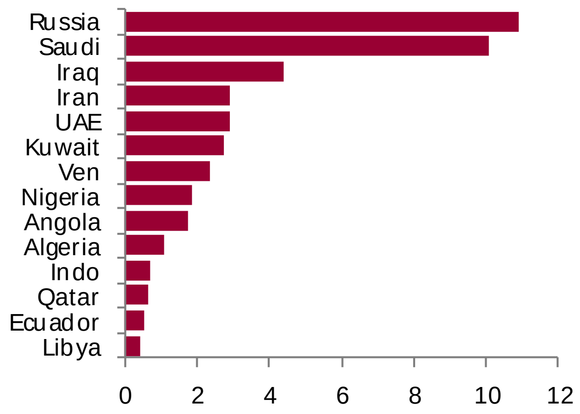
So do we really have a deal and if so what is it?

The conclusion of these various machinations is that some sort of a deal does seem to have been agreed, albeit tentatively and with significant caveats, which should provide a basis for some stability until 2nd June 2016, when OPEC next convenes in Vienna. However, it is also significant that the exact terms of the freeze remain debatable, with a wide variety of January production numbers having already been quoted for various countries (as noted above). It rapidly became clear in the 24 hours preceding the meeting in Tehran that analysts, energy agencies and the countries themselves diverge widely on their production estimates, and as a result there is no consensus on the baseline for what OPEC actually produces. What is clear though is that Saudi Arabia, one of the key advocates of the deal, will pay little attention to what individual countries claim, preferring to base their assumptions on the OPEC output figures in the Monthly Oil Market Report, which is based on secondary sources. On

[19] Reuters, 17 Feb 2016, 'Oil up 7 percent as Iran welcome output freeze without word on cuts'
[20] Reuters, 17 Feb 2016, 'Iran could decide fate of first global oil deal for 15 years'

these numbers, OPEC produced 32.33 million b/d of crude and condensates (not including NGLs) in January. The situation for Russia is less controversial, as both the country and the key statistical bureau, CDU-TEK, place Russian crude output-ex NGLs at a record 10.88 million b/d. The collective total for comparison in June then is 43.21 million b/d.

Figure 3: January production levels, mb/d

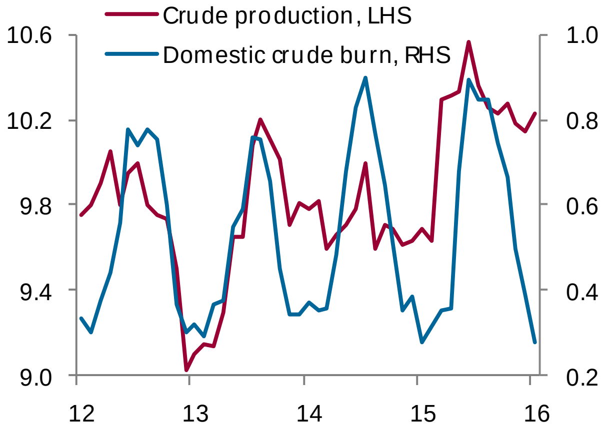


Source: OPEC secondary sources, CDU-TEK

However, compliance or non-compliance with this figure will depend not only on individual country commitment to the accord but also on whether countries actually have the potential to continue producing at the record January levels. Indeed it would seem that output in a number of them is likely to decline over the next few months before rising in the summer. The case of Russia was described above, but in the UAE and Qatar heavy maintenance programmes will affect output in the next few months, while significant capex cuts are likely to start biting into Iraqi production growth. For instance, the UAE will reduce output from the Murban field by 0.2 million b/d in April as works run over from February, and March production is also expected to be lower by 0.3 million b/d. In Iraq, the sabotage of the Kirkuk pipeline has forced a production cutback of at least 80 thousand b/d at the Kirkuk fields. In Nigeria, Shell Petroleum Development Company of Nigeria Limited (SPDC) declared force majeure on Forcados oil export, which could last for a few weeks. As a result, this is likely to have more impact than the agreement to freeze, at least over the next few months, and it is probable that many of the countries who have pledged to keep output steady at January levels are unlikely to be able to maintain such elevated levels of production.

In the summer, however, a different story is likely to emerge. Many Middle Eastern countries, and especially Saudi Arabia, tend to raise production in the summer months as their power generation requirements soar, with direct crude burn still being one key way of meeting this higher demand. The swing between winter and peak summer crude burn in Saudi Arabia is around 0.5-0.6 million b/d and the Kingdom tends to commensurately increase crude production in order to ensure domestic demand does not eat into its exports. Last year, crude burn peaked at just under 0.9 million b/d in June from a low point of 0.28 million b/d in January while production peaked at 10.56 million b/d in the same month, a 0.9 million b/d rise from January's levels. But over the past few months, Saudi Arabia's production has hardly shown any seasonality. While it has come off from the highs, it has stabilised around 10.2-10.3 million b/d since July 2015. Indeed, January's 10.23 million b/d of output was a record high for the month, despite temperatures being mild. So, from current levels, Saudi output would only have to rise by 0.2-0.3 million b/d to match previous summer records. As a result, if the OPEC Group plus Russia freeze output at January levels, it would imply lower crude exports due to higher domestic usage.

Figure 4: Saudi crude output and burn, mb/d



Source: JODI, MEES, Energy Aspects

However, it remains uncertain whether this causal connection can be assumed in 2016, as Saudi Arabia has been targeting export sales at 7 million b/d on average during the last few months. 2015 crude exports having averaged around 7.4 million b/d, and so there is arguably some room for exports to go down in 2016 and still be at an acceptable level as an average over the two-year period. However, the question remains whether the Kingdom will either accept a decline in exports below 7 million b/d in 2016 or whether it will feel the need to increase output in the summer to maintain exports at its preferred level, on the assumption that domestic demand increases by its usual amount.

One way to keep production down but maintain exports is for Saudi Arabia to use alternative sources of fuel for power generation. Domestic crude stocks are at an elevated level (sitting at near record highs of 325 million barrels) and Saudi Arabia also has the ability to burn more fuel oil and diesel for power generation, in particular because current demand levels are lower than peak levels achieved historically in December 2014 and September 2015 respectively. Furthermore, the start-up of the much-delayed Wasit gas plant, can also help the Kingdom avoid having to sacrifice crude exports to meet seasonal demand. As a result, if alternatives can fill the domestic demand gap in the summer, then the dip in Saudi summer exports need not be more than usual (exports usually dip by 0.2-0.4 million b/d in the summer relative to winter months).

In consequence, despite all the excitement about the freeze, it would seem that it will not alter short term oil market balances as all the producers (excluding Iran who are unlikely to comply in any case) were effectively already producing at record levels. Furthermore, it is also unlikely to temper export levels out of Saudi Arabia due to the usual upswing in domestic demand during the summer, meaning that oil market balances will hardly shift from their expected patterns as a result of the latest Saudi-Russia accord.

Has there been a shift in Saudi oil policy?

However, having said that the freeze amounts to almost no change in output, with the Saudis confirming their position that they will not act unilaterally and still expect higher cost producers to be forced to rein in production first, nevertheless it did demonstrate a recognition from the Kingdom that some action is required and should at least be discussed over the next few months, depending upon market developments and the conduct of other players. Saudi Arabia could not just dismiss what was a good proposal from the Venezuelans and the Russians, even if they do not necessarily trust that all participants will abide by any agreement. Furthermore, if this limited action can provide a short-term boost to prices, then the Saudis would clearly be happy to accept any revenue gain. If not (as currently appears to be the case), then the accord can at least be the start of a further negotiation. As Saudi oil minister Al-Naimi was quoted as saying the ‘reason we agreed to a potential freeze of production is simple: it is the beginning of a process which we will assess in the next few months and decide if we need other steps to stabilise and improve the market.'[21]

Importantly, too, the messaging of the Saudi response is crucial, as always. The communique was not dismissive about the probability of coordinated cuts being successful and did not focus on market share maximisation and leaving it completely to the market to rebalance, but was in contrast more accommodating and hinted at further proactive steps being taken, should they be needed. Al-Naimi reiterated this position in a recent speech declaring that Saudi Arabia is open to cooperative action to stabilize the market.[22] Any future deals would still be on Saudi terms, and there was no suggestion that the Kingdom will reduce its own output. Indeed, it continues to focus its attention on competing for sales to Europe as Iran ramps up their exports to the region post sanctions.

A first step in what is likely to be a lengthy negotiating process

What is becoming clear, though, is that the current accord is not the finished article. All the main players are establishing their opening bargaining positions for a lengthy negotiating process, with the issue of Iran's return to the market being perhaps the most important item on the agenda. It would certainly seem that in order to move the discussion forward from here, Iran will need to be offered some concession, especially as Oil Minister Zanganeh has confirmed his view that 'it is very ridiculous, they come up with the proposal on freezing oil production and call for this freeze to take place in their 10 million barrels a day production vis-a-vis Iran's 1 million barrels a day [planned production boost]'.[23] A clear solution would be that Iran might be asked to agree to a more gradual increase in exports, but the negotiating path to reach this outcome could be awkward and lengthy.

Given the somewhat tense relations between Iran and Saudi Arabia over a number of political issues in the Middle East, though, it will be important to see who can intermediate any negotiations. Smaller OPEC countries such as Qatar or Venezuela could have a role, but the emergence of Russia as a friend of Iran but also an oil market ally of Saudi Arabia could now give it an important part to play. Since the announcement in 2015 that sanctions against Iran would be lifted Russia has made great efforts to position itself as a significant commercial and political partner for the Iranians, sealing significant arms deals (including the sale of anti-aircraft missiles and potentially also a number of Sukhoi fighter jets) and nuclear projects in the country. Indeed the Iranian defence minister has only just concluded a visit to Moscow during which a potential $8 billion of further deals were discussed.[24] Furthermore, Russia already appears to be involved in discussions over production levels, with the country's Energy Minister Alexander Novak commenting that 'Iran has a generally fairly constructive attitude to those proposals that our four countries are making'.[25]

Importantly Energy Minister Novak will be visiting Iran on February 29 in his role as co-chairman of the Russian-Iranian inter-governmental commission. The current agenda for the visit includes a broad range of economic co-operation matters between the two countries, but it is hard to believe that Russia will not use the opportunity to further discussions with Iran on the oil output issue. Having demonstrated its own willingness, as the largest non-OPEC producer, to encourage co-operation with OPEC, Russia could certainly hope to bolster its position in the Middle East by becoming an intermediary in negotiations with Iran over oil production issues.

Indeed one might argue that there is some pressure on Russia, as well as other OPEC producers, to make the deal work. Saudi Arabia can no longer be accused of not caring about OPEC and non-OPEC pleas for action, and by announcing its willingness to freeze output at January levels, conditional on others doing the same, it has firmly placed the outcome in the hands of its fellow producers. As a result it is now up to countries such as Iraq, Kuwait and Russia to show that they are serious about coordination and cooperation. In the past, it has almost always been Saudi Arabia and its GCC allies who have kept their pledge of output cuts while others have continued to produce at will and 'cheat', which is precisely why there is a significant lack of trust between Saudi Arabia, various other OPEC members and Russia (given their failed promise to deliver cuts during late 1990s/early

[21] Reuters, 16 Feb 2016, 'Saudis and Russia agree oil output freeze, Iran still an obstacle'
[22] Bloomberg, 'Saudi Arabia Open to Cooperative Action to Stabilize Mkt: Naimi', 23 February 2016.
[23] Bloomberg, 23 Feb 2016, "Iran calls Saudi-Russian output freeze ridiculous – Shana"
[24] Reuters, 16 Feb 2016, 'Russia's Putin met Iran's defence minister in Moscow'
[25] Interfax, 20 Feb 2016, 'Iran not ready to join oil output freeze initiative, talks ongoing – Novak'

2000s). If the other countries can prove that they are at least able to keep their relatively simple promise of freezing output at agreed January levels, then Saudi Arabia can consider a collective cut. In this sense, while the output freeze does nothing to alter the current oversupplied global balances, it is a test of general OPEC and non-OPEC resolve, and one that can help to build confidence and trust. Given historical precedent it is obvious that success is not guaranteed, but at least it is the first step in the process.

What chance for a final agreement and/or an OPEC production cut at the June or December meetings?

This does not mean, though, that an OPEC production cut is imminent, as considerable challenges would still face the organisation in arranging and sustaining a coordinated cut in oil production at a time of severe economic distress. Given the mistrust that permeates relationships within OPEC, as well as between key OPEC members and non-OPEC producers such as Russia (who will be requested to join any cuts), there is a very high probability that any effort made to accelerate the rebalancing of the crude market would be doomed to fail. However, this pessimistic view of the likely success of an attempt to cut production does not completely undermine the progress that has been made in reaching the current agreement. For the first time since November 2014, the crude market should be much less sanguine about OPEC policy, as the Saudi perspective has undoubtedly changed, albeit subtly. As a result, all the market players who have been justifiably bearish on the oil price for reasons linked to crude oil fundamentals or other issues such as weak global economic growth, slowing Chinese demand or the strength of the US dollar, now have pause for thought. Indeed, the Saudis, Russians and the rest of OPEC will be hoping that, if nothing else, their latest accord has introduced just enough uncertainty to make those who have been aggressively shorting the oil price at least re-think their strategy for the rest of 2016.

It remains very unclear, though, whether this process can lead to any solid agreement, let alone a production cut, at the forthcoming OPEC meeting in June. At that time there will be little data available to establish whether any compliance with a production freeze has taken place. March nominations and loading programmes have already been released, so output for February and March is unlikely to be affected by the freeze, meaning that April will be the first month when any restraint will be seen. However, the data to prove it will only appear in May, and it seems likely that this will be the only basis for a discussion in early June, as the May data will not be available in time. As a result, most likely the June OPEC meeting could be inconclusive, and the chances of a production cut being agreed are very slim, unless the oil price falls back below $30 per barrel once more. More realistic is that the June meeting will agree to continue monitoring the market as it re-balances in response to the production freeze, meaning that in effect the original Saudi strategy from November 2014 is continuing to be played out.

Some positive action may be taken at the December OPEC meeting, though, as by then global supply and demand should have become more balanced, and this should be visible through stock draws. This perhaps begs the question as to why the Kingdom might choose to cut output in December if stocks have already started to draw by then. One potential answer is that inventories are at record levels and will take months to draw down, so a cut would speed the process up and allow Saudi Arabia to reassert more control of the market. In December a managed production cut could have a more immediate impact, and it may therefore be tempting for Saudi Arabia to encourage further output restraint in order to accelerate the re-balancing of the market and bring oil prices back to a more satisfactory level. However, for this outcome to become a reality, we suspect that the Saudi authorities will want to see general compliance with the initial production freeze strategy (Iran probably excepted), in order to restore their faith that any future production cut has some chance of success.