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Oil Price Signals: What Next for OPEC+?

Executive Summary

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In this presentation, Bassam Fattouh and Andreas Economou analyse the choices facing OPEC+ in light of OECD stocks falling towards their 2013–2017 five-year average and the recent gains in oil prices. In Q1 2018 the Brent price rose, from the trough of Q1 in 2016 ($35/b to $67/b), and on average by $32/b (or 89%), and is currently hovering around $75/b. Largely supported by the current strength of the global economy, OPEC+ succeeded in accelerating market rebalancing by high compliance to the November 2016 agreement to cut output (although the high compliance is in part due to unplanned outages in some member countries). However, there have been concerns that OPEC may be over-tightening the market, with US President Donald Trump blaming OPEC for pushing prices “artificially Very High”, and many commentators warning that current high oil prices will have a negative impact on oil demand and could stimulate an even stronger US shale supply response, eventually pushing the oil price into another downward cycle. An underlying message from these commentators is that OPEC should wind up its output cut deal, releasing the withheld barrels back into the market to put a cap on the oil price.

While OPEC+ should always be wary about the potential supply/demand responses in a higher oil price environment and should show willingness to act both on the upside and the downside, we argue that indicators based on stocks should not be its only guide for output policy and that OPEC+ should retain the flexibility of considering alternative metrics including variations within the five-year average measures (such as excluding the years 2015 and 2016 in which key OPEC producers and Russia pursued a high-output low price strategy resulting in a large stock-build). Metrics based on inventories are problematic: they do not provide well-defined or stable targets, the five-year average is a moving target, OECD oil stocks do not paint a clear global supply-demand picture, and they are lagged and backward-looking indicators.

Most importantly, stock movements should be seen merely as symptoms of underlying oil supply and oil demand shocks hitting the market. For example, assume that OPEC+ has reached its inventory target, however measured, but expects demand to slowdown; should it exit the output cut deal? Clearly the answer is “no” as this would result in a sharp fall in the oil price and hence, the level of inventories is a poor guide for OPEC+ policy decisions in such situations. The fact that the market, the media, as well as producers themselves would prefer to rely on ‘simple’, ‘measurable’ and ‘observable’ indicators, and that indicators based on shocks are highly uncertain as well as difficult to measure (as they are forward-looking), does not mean that OPEC+ should not consider alternative and more complex metrics in their decision making. Aspects such as simplicity and measurability should shape OPEC+ communication strategy, but not necessarily their decision as to whether to exit or not exit the deal.

In this respect, the drivers of prices matter. Our forecasts scenarios show that the latest $5/b oil price increase in April 2018 (as of week-ending April 23, 2018) most likely reflected a geopolitical risk premium. Simulating a number of different upside supply-demand shocks, all else remaining equal, the April price is more responsive to geopolitical risks in the form of either unexpected disruptions in crude oil production (possibly from Venezuela) and/or an increase in the precautionary demand for oil triggered by the US threats against Iran. The latter is consistent with the heightened geopolitical uncertainty in the Middle East witnessed in April, following primarily the US-led strike in Syria and its potential spillover effects, as well as the US-threat to withdraw from the Iranian nuclear deal re-imposing sanctions that could lead to a loss between 0.2m – 0.4 mb/d of Iranian oil exports. In a tighter market, the impact of news about future supply disruptions on stock demand and oil prices is far more severe relative to a falling market.

We conclude that the potential of a renewal of US sanctions on Iran and an escalation of the trade tensions between the US and China increase the range of uncertainties facing OPEC+. We consider OPEC+ exit strategy under different scenarios and find a wide range of potential price outcomes depending on different assumptions about global oil demand growth and geopolitical disruptions. For instance, assuming a scenario in which OPEC+ maintains its cuts while oil demand growth remains robust and geopolitical disruptions accelerate, the oil price would hit \$80/b year-end with the 2018 average Brent price reaching \$72.5/b. In contrast, a scenario in which OPEC+ exits the deal but oil demand growth slows down would push the average price to \$50/b even if the geopolitical disruptions don’t ease. It is perhaps this wide range of price outcomes, which may explain OPEC+ reluctance to exit the deal, especially given the time taken and the difficulties in concluding the output cut agreement and the realization that rebuilding a ‘coalition of willing producers’ will not be easy this time round if market fundamentals change and price signals are ambiguous. What makes it more difficult for OPEC+ is that their decisions are endogenous and how they decide to act now will, in turn, shape market outcomes adding another layer of uncertainty.