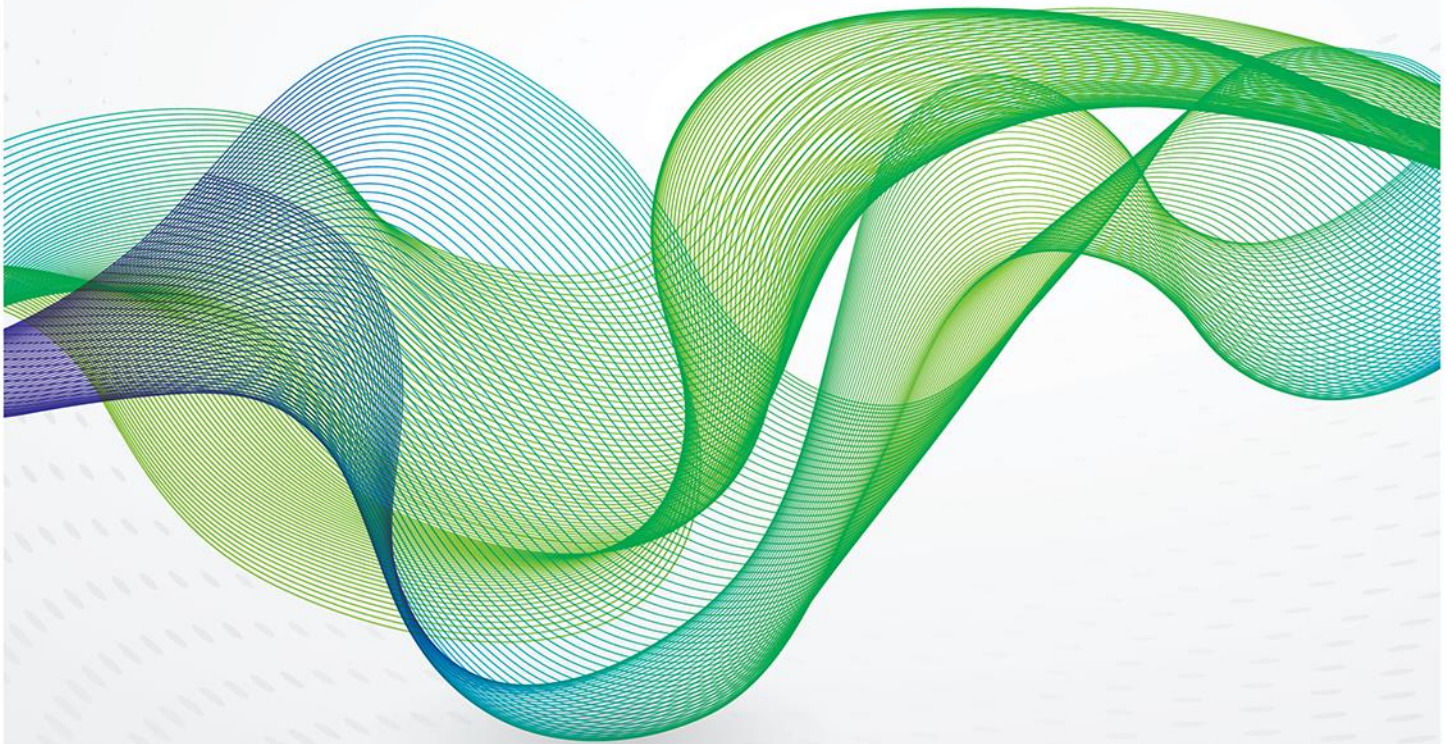


May 2018

Is this the end of the OPEC+ deal?



President Trump's recent decision to exit the Joint Comprehensive Plan of Action (JCPOA) and the expectation therefore of the loss of Iranian barrels has brought the fate of OPEC+ deal to the fore. For some analysts, this signifies that 'the current OPEC deal will end by end-2018'¹ while for others, the impact may be felt as soon as the next OPEC meeting in June this year as it will be no 'longer about extending the production cuts, but rather about when to start raising output gradually'.² At the other end of the spectrum, some argue that 'there is no pressure from within the group to bring their cooperation to an end' and the 'deal will run until the end of 2018 and could be extended again if participants don't believe that the market has been rebalanced'.³

These very different views reflect the hard choices that OPEC, and its dominant player Saudi Arabia, faces in a more uncertain and geopolitically charged market. On the one hand, Saudi Arabia welcomed Trump's decision to scrap the Iran nuclear deal as the deal has allowed Iran to 'continue its destabilizing activities'⁴ and the Kingdom showed its willingness to meet any supply shortages, assuring the market that it has enough spare capacity to 'maintain oil market stability'. On the other hand, Saudi Arabia is committed to 'rebalancing' the market (which in OPEC's view has not yet been achieved) and would continue to do so in cooperation with other producers (some of whom are opposed to Trump's decision to exit the Iran deal) and therefore will not act unilaterally to offset any potential supply shortage.

Given these multiple objectives, Saudi Arabia needs to engage in a delicate balancing act and hence the decision to terminate the OPEC+ deal is not as straightforward and binary as it is often portrayed. Issues such as the timing of any potential response to Iranian output loss, the type of the response (unilateral or collective), and the way producers decide to exit the deal (assuming that they decide to terminate the output cut agreement) are all important in shaping oil market and price outcomes. So what are some of the key factors that may shape OPEC+ decisions in the next few months?

First, there is uncertainty surrounding the size of the potential loss of Iranian barrels, with estimates ranging widely from 200 thousand b/d⁵ all the way to 1.5 mb/d⁶ though most estimates lie in the lower range (between 200-500 thousand b/d with the 1.5 mb/d figure being an outlier). Also there is little expectation of an immediate loss of Iranian barrels. The size of the output loss will depend on a large number of factors that are still not known (not even to the US administration!), in reality, no one really knows. Saudi Arabia's output response will primarily be shaped by the size of the output loss (an obvious point but much ignored in the current debate). If the loss is in the lower range (say 200 thousand b/d), then this is a small aberration to a market the size of almost 100 mb/d. In fact, one could argue that the most immediate geopolitical risk, that is far more relevant in the short run than the Iranian sanctions, stems from the immediate risk of losing at least a further 200 thousand b/d⁷ from Venezuela. In a worst case scenario in which the combined output loss from Iran and Venezuela is large, Saudi Arabia will have to strike a balance between how much it increases output and how much spare capacity it should maintain. In an environment of declining stocks and rising geopolitical tensions, low spare capacity will keep an upward pressure on the oil price.

Second, a key issue remains as to whether Saudi Arabia should respond to the current rise in the price level, even if this rise is only temporary and not fully driven by changes in market fundamentals. While many see the current rise in oil price reflecting much tighter market fundamentals (and the expected losses from Iran will only make the situation worse), not all the data points are facing in the same direction. For instance, the latest available data show that while Brent prices have risen sharply, some of the physical differentials especially for West African crudes have been weakening and West African barrels have been struggling to find a home in Europe or Asia (see Figures below). Also in a

¹ Grant Smith and Javier Blas 'Iran Crisis Warps OPEC Equation as Saudis Signal More Supply, Bloomberg, 9 May 2018.

² Grant Smith and Javier Blas 'Iran Crisis Warps OPEC Equation as Saudis Signal More Supply, Bloomberg, 9 May 2018.

³ Julian Lee, OPEC's Output Deal Will Shrug Off Iran Sanctions, 13 May 2018.

⁴ Kingdom of Saudi Arabia's Statement on the United States Withdrawal from the JCPOA, Saudi Press Agency, 9 May 2018.

⁵ David Rami Jalilvand, Progress, Challenges, Uncertainty: Ambivalent Times for Iran Energy Sector, OIES Energy Insight, April 2018

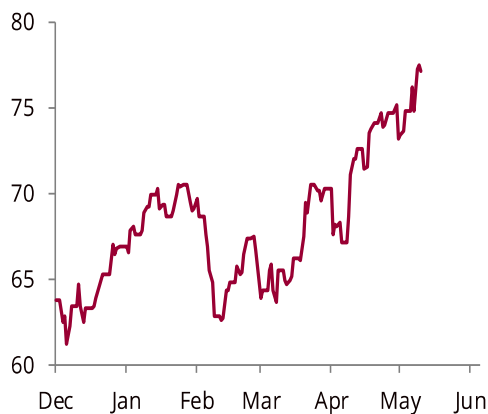
⁶ Bloomberg, Bloomberg, FGE's Fesharaki Sees 1.5 Million Barrels of Iran Oil Removed Per Day, May 9 2018.

⁷ <https://www.bloomberg.com/news/videos/2018-05-09/fge-s-fesharaki-sees-1-5-million-barrels-of-iran-oil-removed-per-day-video>

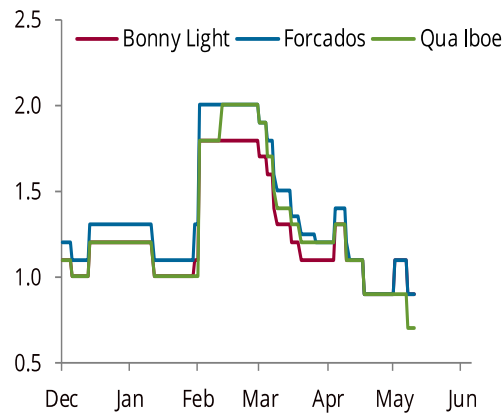
⁷ see <https://www.bloomberg.com/news/articles/2018-05-10/pdvs-a-learns-that-conoco-pain-may-be-worse-than-u-s-sanctions>). Moreover, with the upcoming presidential elections on May 20, it is unclear how the crisis will unfold in the coming months.

recent work, we show that the oil price increase in April 2018 most likely reflected a geopolitical risk premium. Simulating a number of different upside supply-demand shocks, all else remaining equal, we found that 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.⁸ Overreacting to short-run price signals and adding extra OPEC barrels immediately in this current market could put downward pressure on time spreads. In this respect, it is important that OPEC monitor and anticipate any release of crude from the Strategic Petroleum Reserves (SPR) by the US government. On the other hand, rising oil prices can slow demand growth and given the important role that positive oil demand shocks played in rebalancing the market in the last few years⁹, OPEC will be keen not to endanger global oil demand prospects, but the latest message from Saudi Arabia is that the oil market has ‘the capacity to absorb higher prices’.¹⁰

ICE Brent, \$/barrel



Nigerian diffs to Dated Brent, \$/barrel



Source: Energy Aspects

Third, the choice confronting OPEC+ is not binary i.e. to exit or not exit the output cut agreement. There are plenty of options between these two extreme positions. In practice, they could decide to increase output gradually without necessarily scrapping the agreement or modify the ceiling depending on market conditions. The fact that OPEC compliance is well above 100 per cent gives the Organization a lot of room to increase output and still comply with the collective output ceiling. Of course, this would result in the reallocation of output gains and losses within the Organization. But this will not be the first time this has happened: whenever there has been an output disruption in the past, those producers with spare capacity and the ability to increase output improve their production share at the expense of the disrupted countries. Moreover, with sustainable capacity levels for some members such as Angola, and most importantly Venezuela, having fallen below the allocated production targets of November 2016, a revision of the 2016 production targets should not come as a surprise. Currently, within OPEC+, Saudi Arabia, Russia, Kuwait and UAE are the main countries that can increase output in a relatively short period of time as the remaining countries are producing close to or at their maximum capacity.

⁸ See B. Fattouh and A. Economou, Oil Price Signals: What Next for OPEC+? OIES Presentation, <https://www.oxfordenergy.org/wpcms/wp-content/uploads/2018/05/Executive-Summary-Oil-Price-Signals-What-Next-for-OPEC.pdf>

⁹ See B. Fattouh and A. Economou, ‘Oil Supply Balances: The Four Cycles of the OPEC Oil Output Policy’, OIES, <https://www.oxfordenergy.org/wpcms/wp-content/uploads/2014/07/Executive-Summary-Oil-Supply-Balances-The-Four-Cycles-of-the-OPEC-Oil-Output-Policy.pdf>

¹⁰ Al Arabiya English, Market has capacity to absorb higher oil prices, says Saudi minister Falih, April 20 2018, <http://english.alarabiya.net/en/business/energy/2018/04/20/Oil-set-for-weekly-gain-on-supply-cuts-strong-demand.html>

Finally, it took a long time and massive effort for OPEC+ to reach the output cut agreement in 2016. The key producers had to engage in diplomacy at the highest level as well as engage in ‘production games’ that resulted in a record output and stock build in the fourth quarter of 2016 and delayed ‘market rebalancing’ by months. It is in OPEC+ interests to avoid a repeat of such dynamics. This does not mean that producers are bound forever to this agreement, but the way producers decide to exit the deal does matter. Producers will want to avoid any disorderly or unilateral exit as this will alter market expectations about producers’ cooperation and could fundamentally impact prices and sentiment. All countries involved, including Saudi Arabia, must realize that rebuilding a ‘coalition of willing producers’ will not be easy this time round if market fundamentals change and current price signals are not accurate. But ensuring an orderly exit is not an insurmountable task given that there are very few countries with spare capacity (Saudi Arabia, UAE, Kuwait and Russia) and the country most affected from President Trump’s decision (i.e. Iran) can’t block the continuation or the termination of the deal.

As has been discussed the decision to exit the OPEC+ deal is highly nuanced, and it is by no means a forgone conclusion that this year will witness the termination of the OPEC+ deal. Saudi Arabia is faced with new political realities following the US decision to withdraw from the nuclear deal and needs to react to any potential shortages and price rises - which President Trump has already described as ‘artificially very high’. At the same time, it can’t endanger the rebalancing process risking oil prices going lower and seeing its revenues decline. This calls for a flexible approach. In the last few months, OPEC+ has been gradually signaling to the market a shift away from the average of the five-year OECD stocks to alternative metrics including different calculations of the five-year average (for instance by excluding ‘outlier’ years). This is a debate that will not go away so long as the political will to maintain the deal remains. OPEC+ have some flexibility in terms of when to increase output, how much to increase output by, how to communicate their decision to the market, and whether any response should fall within the parameters of the existing deal. Such flexibility is needed more than ever and will be fully utilized and the market should not expect stark decisions or the announcement of a major reversal in policy in the next few months. Considering that there is a period of three to six months before the renewed US sanctions are fully reinstated,¹¹ perhaps the easiest outcome would be for OPEC to announce at its June 2018 meeting that the ‘mission has not yet been accomplished’ and to push any hard decisions to the November 2018 meeting when the OPEC+ producers will have to decide the future of the deal anyway. This continues to make OPEC behaviour a key factor shaping market outcomes in 2018. This may not be comforting news for those who, not that long ago, predicted the irrelevance of OPEC in the age of US shale.

¹¹ The Economist, ‘Sanction on Iran: The highest level’, from the print edition May 12th-18th 2018.