Energy February meet in June 2018. That OPEC/NOPEC should be very wary about unwinding the output cut agreement when they next meet in June 2018, if they want to maintain the recent price gains, they have to extend their output cut until the end of 2018; releasing supply into the market will rebalance the market and support the oil price. Finally, our results show that for OPEC/NOPEC it is important that the strong oil demand momentum experienced in 2017 continues, which requires a ceiling on oil price risks conditional on certain events that are known in advance. However, higher US shale output may support a price above $65/b. Our results show that for 2018, US shale output growth will be the key factor putting a ceiling on the oil price, while supply disruptions could provide some support to the oil price. For Brent, we expect prices to be supported at around $65/b, with a price floor at above $60/b and a ceiling at $80/b, depending on how the oil price path could evolve in 2018. With very divergent views among market observers about how the oil price path could evolve in 2018, with some revising upwards their forecasts to expect prices above $70/b, expecting a lower path in the mid $60/b. The key uncertainties behind these divergent views mainly pertain to different views about: the extent of supply disruptions amid a fragile geopolitical environment; the potential impact of higher oil prices on global oil demand; the OPEC/NOPEC exit strategy from the output cut agreement reached in November 2016; and the US shale supply response to the recent oil price rise; and finally, the role of inventory changes in determining the oil price. In this Energy Insight, we analyse how the oil price path could evolve in 2018 by evaluating the aforementioned risks underlying the world oil market using a structural model of the oil market and considering various forecast scenarios. Forecast scenarios are not predictions of what will happen, rather modelled projections of various oil prices conditional on different events. Our reference forecast scenario projects an oil price of $75/b, with a 2018 average price of $67/b. The baseline forecast suggests that the momentum of strong oil demand and the OPEC/NOPEC output cuts will still be very important for the oil price, while supply disruptions could provide some support. Currently, there is still a wide uncertainty engulfing the oil market, and current forecast scenarios suggest that prices could range from below $60/b to above $80/b.
Saudi Arabia’s oil policy

Multiple factors shape Saudi oil policy

1. Domestic structural features:
   - Massive oil and gas reserve base which will take many decades to exhaust;
   - High dependency of the economy on oil revenues;
   - Only oil-producing country with an official policy to hold spare capacity;
   - Political leadership (high spending requirements, more assertive foreign policy, geostrategic relations with major superpowers).

2. Cohesions within OPEC and relations with non-OPEC.

3. Nature of shocks hitting the oil market (temporary vs. structural) and the wide uncertainties associated with oil shocks.

   *Saudi oil policy should be analysed in the context of multiple objectives, trade-offs, internal constraints and few policy tools available.*

Saudi Arabia oil policy is not constant, but it evolves in a dynamic context as trade-offs change over time, conduct of players change and uncertainties are resolved as new information arrives.

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**Saudi Arabia oil statistics**

- **Reserves**
- **Crude production**
- **Domestic consumption**
- **Refinery capacity**
- **Crude exports**
- **Oil rents**

Data: BP, World Bank, OIES

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What is this relationship about?
The Saudi – Russia oil ties

In 2017, King Salman became the first ever Saudi Monarch to visit Russia cementing the KSA-RUS ties

- The Saudi Arabia – Russia relationship has mainly centred on oil and energy relations.
- The expansion of this relationship to other non-energy related areas has been limited.
- There are major disagreements on multiple fronts including Iran, Syria, Qatar and Yemen.
- Improved oil relations will contribute little to nothing to bringing the parties closer on other regional issues.

Source: Getty Images

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Has the relationship contributed to shaping market outcomes?
Several episodes illustrate the extent of the change

KSA and Russian output growth, Jan 15 – Dec 16

Cooperation between KSA and Russia cemented the foundation for reaching the Declaration of Cooperation in December 2016 that constituted an unprecedented milestone in the OPEC/NOPEC producers’ relations.

OPEC* target and actual output cutbacks

The unprecedented conformity levels achieved by the OPEC* producers, led by KSA and Russia, surprised the market and proved that both producers were committed to bringing the market into balance.
Another milestone has been the recent coordinated shift in output policy.

Before the OPEC meeting in June 2018, KSA and Russia agreed to increase production outside the framework of producers’ cooperation. Output hikes from the producers reached almost half the entire OPEC target cut (0.53 mb/d).

KSA and Russia pushed for 100% compliance, allowing for those producers who could increase output to do so above their individual quotas. Notably, OPEC+ compliance from June to August 2018 averaged at 99%.

Data: IEA, OIES
Private deal in September?

KSA-RUS output deal to cool rising prices

- Reuters reported that Russia and Saudi Arabia struck a private deal in September 2018 to raise oil output and informed the US before a meeting in Algiers (JMMC Meeting) with other producers.

“The deal underlines how Russia and Saudi Arabia are increasingly deciding oil output policies bilaterally, before consulting with the rest of OPEC”

- Khalid al-Falih at a Moscow energy forum in October confirmed that the Kingdom increased its output in September and plans to raise its oil production further in November from an October level of 10.7 mb/d to meet rising crude demand.

- The Saudi Arabian Energy Minister added that the Kingdom was in weekly communication with Russia to stabilize the global oil market.

Source: Reuters
Is the oil relationship symmetric?
Despite a strong unified signal to the market, asymmetry exists

Saudi Arabia leads the producers’ pack

- Saudi Arabia still does most of the heavy lifting when it comes to rebalancing the oil market.
- Notion that Russia calls the shots is misguided.
- Without Saudi Arabia there would be no producers’ agreement and without GCC(3) output cuts the market would have taken much longer to rebalance.
- Though, without Russian participation it would have been more difficult for OPEC producers to reach an agreement in November 2016.
- Also, Russia did commit to its pledged output cutbacks this time round and contributed to the market rebalancing and the price recovery process.

An agreement to adjust output between two of the world’s largest producers sends a strong signal to the market and currently any break in this alliance will affect market sentiment.
How did this relationship evolve?
Oil market cycles and structural transformations within KSA

Current oil policy shaped by the 1980s experience

- In the early 1980s, OPEC was faced with multiple shocks on both the supply and demand sides.
- Saudi Arabia tried to defend the price but ended up cutting large volumes of production without succeeding in reversing the price declines and resulting in huge drop of oil revenues and market share.
- The failure of Saudi Arabia to reverse the price collapse at the time reflects the underlying nature of the shocks hitting the oil market: that is structural rather than temporary.

Since then, Saudi Arabia has taken a strategic decision not to balance the market on its own.

- Any output cut thereafter has to be done in agreement with other producers within and outside OPEC and as such in every episode that followed KSA insisted on collective cuts (e.g. 1998, 2001, 2008, 2016).

Comparison of non-OPEC production growth between 1980-88 and 2008-16
There were many attempts to involve Russia on collective cuts

Albeit, the history of Russia cooperation with OPEC is bleak

In the aftermath of the 1998 oil price collapse, Russia agreed to cut its production by 0.1 mb/d as part of an agreement between OPEC and non-OPEC oil producers, but in reality output rose by 0.31 mb/d.

In 2001, OPEC promised an output cut of 1.5 mb/d if non-OPEC producers could find a further 0.5 mb/d reduction. Initially, Russia responded by making an offer of a 0.05 mb/d cut. Russia later announced a cut of 0.15 mb/d in December 2001 but ultimately delivered no reduction at all.

In 2008-09, Russia’s Deputy Prime Minister Igor Sechin attended three consecutive OPEC meetings as an observer, setting off widespread rumours that the oil producer might consider joining OPEC.

He told OPEC delegates in December 2008 that Russia may restrict its supplies by 0.32 mb/d throughout 2009 to support prices. Despite this, during negotiations Russian output rose by 0.32 mb/d before declining by 0.14 mb/d year-end.
In 2014, Saudi Arabia decides to pursue market share strategy

OPEC’s fundamental dilemma in 2014

- In 2014, Saudi Arabia was reacting to an imbalance caused by fundamental forces unleashed by high oil prices.

In face of imbalance two options:
Cut output or leave it to the price mechanism to clear the market?

Factors shaping Saudi Arabia’s decision in favour of pursuing market share strategy (i.e. the second option):

1. Size of market imbalance in 2014 was relatively large.
2. Unwillingness to act unilaterally to balance the market; a fundamental principle shaped by 1980s experience.
3. Difficulty of reaching an agreement within OPEC and with non-OPEC producers as the pain of lower oil revenues was not widely felt and many countries had ambitious plans to increase productive capacity.
4. Saudi Arabia built strong fiscal buffers during the boom years and perhaps belief that it could withstand a lower-for-longer oil price.
5. US shale introduced a new set of structural uncertainties, unlike the 2008 temporary shock, which limited Saudi Arabia’s ability to respond, at least in a sustainable way.
The long journey to reaching an output cut deal

No oil exporter is immune to sharp falls in oil revenues

- In 2016, Saudi Arabia showed willingness to freeze output and cooperate with other producers, but signal was not always clear and in 2H position shifted from freezing to cutting output.
- Failure of Dohan meeting to freeze output brought Saudi Arabia-Russia oil relations to a very low point.
- Russia and Saudi Arabia seemed a long way apart after the Doha meeting in April 2016.
- However, a series of inter-governmental meetings and agreements on lower level technical cooperation between Russia and Saudi Arabia provided a foundation for further talks.
- Key was the G-20 summit in China in September 2016, after a meeting between President Putin and Crown Prince Mohammed bin Salman in which they discussed avenues to cooperate on the oil front.

It took a long time to reach an agreement; output from the negotiating OPEC and n-OPEC producers surged before the implementation of the agreed cuts.
So, why now?
Fall in oil revenues was the key factor

Despite adjustment measures, fiscal challenges persisted

- Confronted by a sharp price fall in 2016 and the fall in oil revenues, Saudi Arabia had to reverse its course and seek cooperation with other producers.
- The Kingdom soon realised that despite the adjustment measures to a low oil price environment, these had not been enough to address its fiscal challenges:
  1. Draw down on foreign reserves;
  2. Increase domestic lending;
  3. Tap international debt markets;
  4. Increase domestic energy prices;
  5. Reduce capital spending;
  6. Boost non-oil revenues;
  7. Devaluation (albeit, it was never really on the table).

Saudi Arabia is constrained by the fact that its economy is highly reliant on oil revenues at a time when its spending keeps increasing.

KSA gross oil revenues v market share, 2000-17

Data: OPEC, OIES
Change in Saudi power structure

Consolidation of power in the hands of MBS

- The change in Saudi power structure and the unprecedented consolidation of power within the hands of Crown Prince Mohammed bin Salman (MBS) who controls the Kingdom’s main pillars:
  1. Economy;
  2. Defence;
  3. National guard;
  4. Intelligence;
  5. Foreign policy.

- MBS pursued a more assertive foreign policy emboldened by closer alliance with the US and heightened threats from Iran.

- At the same time diversifying its foreign relations.

- The politics of ‘strong men’.

MBS pushed for the agreement with Russia at the highest level.

G20 Summit in Hangzhou China, 4 Sep 2016
Featuring Russia’s President Vladimir Putin during a meeting with Saudi Arabian Crown Prince Mohammed bin Salman
Has the relationship been successful?
The KSA - Russia cooperative framework worked remarkably well

**OPEC** output compliance, Jan 17 – Aug 18

![Graph showing OPEC output compliance from January 2017 to August 2018](image)

Both OPEC and non-OPEC producers in the DOC exhibited higher than expected output compliance to their pledged targets, with KSA leading the pack. Since June 2018 compliance remains near 100%.

**Direct impact of the DOC on Brent price, Jan 15 – Jun 18**

![Graph showing direct impact of the DOC on Brent price from January 2015 to June 2018](image)

The producers’ cooperative framework under DOC accelerated the price recovery, adding more than $10/b to the Brent price, despite strong US shale growth and supported by favourable demand conditions.

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Can this relationship continue?
But the relationship is yet to be seriously tested

- It is highly likely that Saudi Arabia and Russia will maintain a close level of cooperation even after the expiration of the current output cutback deal.

- According to media reports, both OPEC and non-OPEC producers are aiming to formalise their long-term cooperation later this year by approving a charter that will make further joint coordination of oil policies, aimed at stabilising the oil market, possible.

- However, despite its short-run success, a long-term cooperation is faced with multiple challenges of a different nature compared to the current short-run cooperative framework.

- Relationship yet to be tested: What if there is a negative demand shock and US shale continues to increase and the cuts needed to balance the market are large?

But the alternative of non-cooperation also comes with a high cost.
Will this renewed relationship reduce the importance of OPEC for Saudi Arabia?
Bassam Fattouh, Director OIES

October 2018

Oil Price Paths in 2018: The Interplay between OPEC, US Shale and Supply Interruptions

Abstract

2018 started on a positive note for oil markets with Brent prices breaking through $70 a barrel for a few days and all the key international crude oil benchmarks flipping into backwardation. Yet, there is still a wide uncertainty engulfing the oil market, with very divergent views among market observers about how the oil price path could evolve in 2018, with some revising upwards their forecasts to higher than $80/b while others are less convinced that the market fundamentals can sustainably support a price above $70/b, expecting a lower path in the mid $60/b. The key uncertainties behind these divergent views mainly pertain to different views about:

- The OPEC/NOPEC exit strategy from the output cut agreement reached in November 2016;
- US shale supply response to the recent oil price rise;
- The potential impact of higher oil prices on global oil demand;
- The extent of supply disruptions amid a fragile geopolitical environment.

In this Energy Insight, we analyse how the oil price path could evolve in 2018 by evaluating the aforementioned risks underlying the world oil market using a structural model of the oil market and considering various forecast scenarios. Forecast scenarios are not predictions of what will happen, but rather modelled projections of various oil price risks conditional on certain events that are known at the time of the forecast or some other hypothetical events. Our reference forecast scenario projects for Brent to trade within a narrow price range, with a price floor at above $60/b and a ceiling of below $75/b, with a 2018 average price of $67/b. The baseline forecast suggests that the momentum of stronger than expected oil demand and the OPEC/NOPEC output cuts have tightened the oil market in 2017 and even with no change in current market dynamics, the oil price will continue to be supported at around $65/b. Our results show that for 2018, US shale output growth will be the key factor putting a ceiling on the oil price, while supply disruptions could provide some support to the oil price, with a sharp fall in Venezuelan output constituting the biggest geopolitical risk that could push prices well above our baseline or reference forecasts. The results also show the paramount importance for the strong oil demand momentum experienced in 2017 to carry on into 2018 for rebalancing the market and supporting the oil price. Finally, our results show that for OPEC/NOPEC to maintain the recent price gains, they have to extend their output cut until the end of 2018; releasing the withheld barrels under the current agreement would result in a sharp fall in oil prices, suggesting that OPEC/NOPEC should be very wary about unwinding the output cut agreement when they next meet in June 2018.