November 2018

OPEC Choices are Getting Harder and Harder

Executive Summary

Bassam Fattouh & Andreas Economou

Oil market sentiment has turned very bearish over the last few weeks. The Brent price has fallen from highs of above $80/barrel in October to currently trading close to $60/barrel, global economic prospects have become highly uncertain, Saudi Arabia's production is at record level of above 11.1 mb/d in November, Russia and other OPEC+ members that could increase production are producing at or close to maximum capacity, the range of estimates of Iranian losses remain very wide, OECD liquids stocks have returned to above their 5-year average, net-length financial positioning has fallen sharply, US shale output keeps surprising on the upside, and President Trump's tweets about OPEC and oil prices have become a regular occurrence. Thus, when OPEC+ members meet next in December, they find themselves in a very different environment than the June 2018 meeting when the market's main concern at the time was whether Saudi Arabia has enough spare capacity to put a cap on the oil price. In contrast, in the forthcoming OPEC meeting, the market concern is whether OPEC and its partners will implement deep enough cuts to reverse the recent decline in the oil price.

This short presentation assesses the various choices that OPEC and its key player Saudi Arabia face. It makes the following three key observations:

- Had Saudi Arabia, Russia and the other exporters capable of increasing output not increased output between April and October, global oil production would have been lower in October by 1.8 mb/d. But even with this lower level of production, oil prices would only have reached low $80s/b (only $2/b on average above the actual price), implying that most of the increase in the oil price in September and October was driven by expectations about large losses of Iranian output. In fact, our results show that supply and demand factors contributed little to price movements during this period, while speculative demand, due to a shift in expectations, accounted for the bulk of the price increase. Thus, any revisions in these expectations would have resulted in a sharp fall in the oil price. And indeed, this revision in expectation did happen. The U-turn in the US government's position, and its willingness to grant waivers to a number of Iranian oil importers to prevent a spike in the oil prices, along with perceptions of abundant supplies due to higher production from key OPEC producers and Russia did cause a drastic shift in market expectations, accounting, in no small part, to the fall in the oil price.
- Looking ahead, Saudi Arabia faces very hard choices, while it is being subject to few constraints in its output policy. If the current decline in oil price is driven by structural shifts in supply-demand fundamentals, then Saudi Arabia may be reluctant to cut oil output. After all, the Saudi Energy Minister Mr Khalid Al-Falih has made it clear on many occasions that the Kingdom will not intervene in the market to correct a structural imbalance (for instance in the CERA conference in 2017, Al-Falih stated that 'history has demonstrated that intervention in response to structural shifts is largely ineffective', that Saudi Arabia has learned that lesson and 'that's why Saudi Arabia does not support OPEC intervening to alleviate the impacts of long-term structural imbalances, as opposed to addressing short-term aberrations such as financial crises, economic recessions, unforeseen supply disruptions, or the like'). On the other hand, if the recent declines in the oil price have been driven by speculative demand

pressures and by deterioration in expectations then Saudi Arabia will be pushing for cuts to stabilize market expectations and reverse the stock-build. So how Saudi Arabia perceives the shock will be one of the key determinants of its output decision next week. Our results show if Saudi Arabia where to cut its output back to April 2018 levels (i.e. by -0.73 m/d from its October level) in the face of unfavourable markets conditions (for instance a drastic slowdown in global oil demand and large increase in US shale production), the price gains will be small and short-lived. In contrast, if the recent decline in the oil price is driven by speculative demand and change in expectations, associated with a large build-up in stocks in anticipation of a price increase due to the Iranian sanctions, then oil price gains could be maintained within the $70/b and $80/b range.

- However, the nature of the shock is not the only factor that will determine Saudi Arabia's policy. Unlike in 2014 when Saudi Arabia decided not to cut output in the face of a structural shock to market fundamentals (slowdown in demand growth, rise in US shale production, and the return of many disrupted countries to the market), the Kingdom's current fiscal buffers are thinner and the prospects for its economy and private sector are weaker, while government spending keeps rising, which implies that Saudi Arabia does need a higher oil price. Also the political backdrop, both domestically and internationally, has been transformed and many market participants have doubts about the ability of Saudi Arabia to isolate political factors from its oil output decisions. Saudi Arabia may still not cut output even if it believes the shock is temporary and/or if other producers are not willing to join the cut; there is also the possibility it may decide to cut output even if it believes the shock is more permanent in nature. These constraints, whether they are real or perceived, influence price outcomes and market perceptions and may require the Kingdom to act and signal differently than in the past few months.