THE OXFORD INSTITUTE FOR ENERGY STUDIES

OPEC Choices are Getting Harder and Harder

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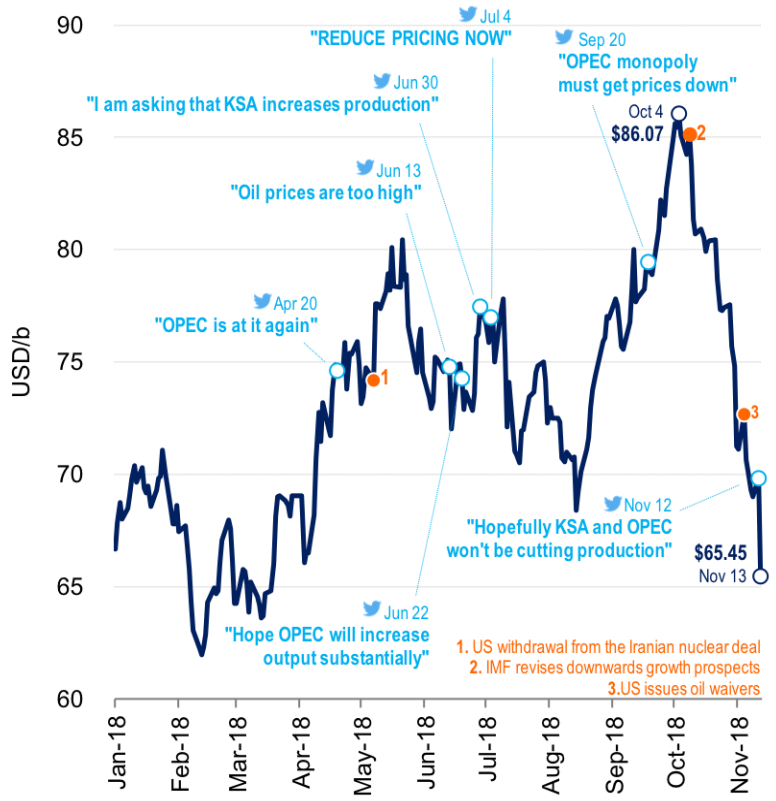
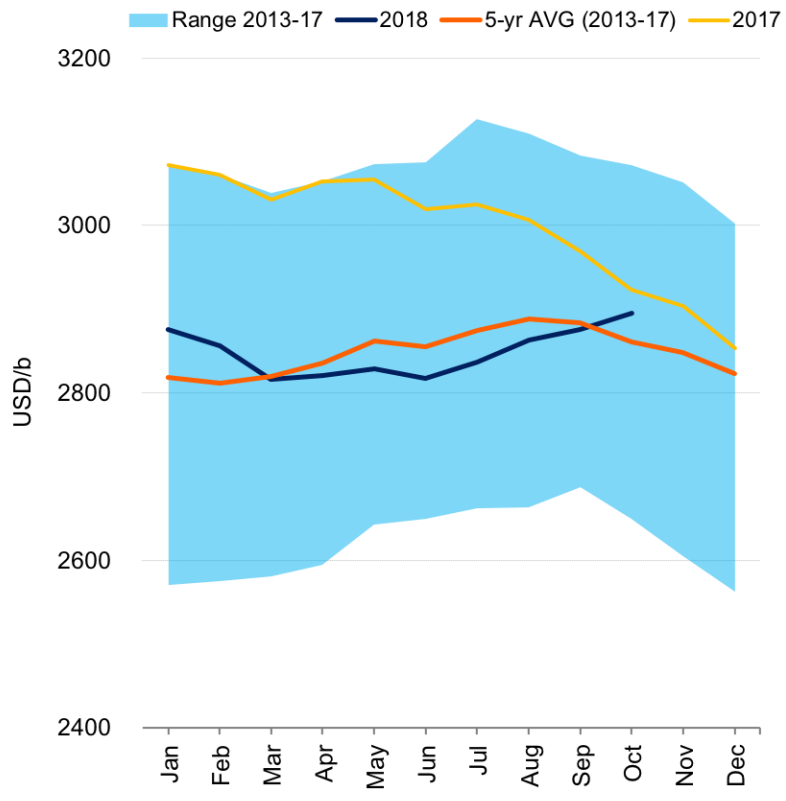
Oil market sentiment turns sour

Daily Brent price and information signals, Jan – Nov 18



Oil market sentiment has turned very bearish over the last few weeks. The Brent price has fallen from the high levels of above $85/b in October and is currently trading close to the low-$60/b. This raises the question if the latest price drop reflects shifts in fundamentals or expectations or both?

OECD total liquids stocks in 2018

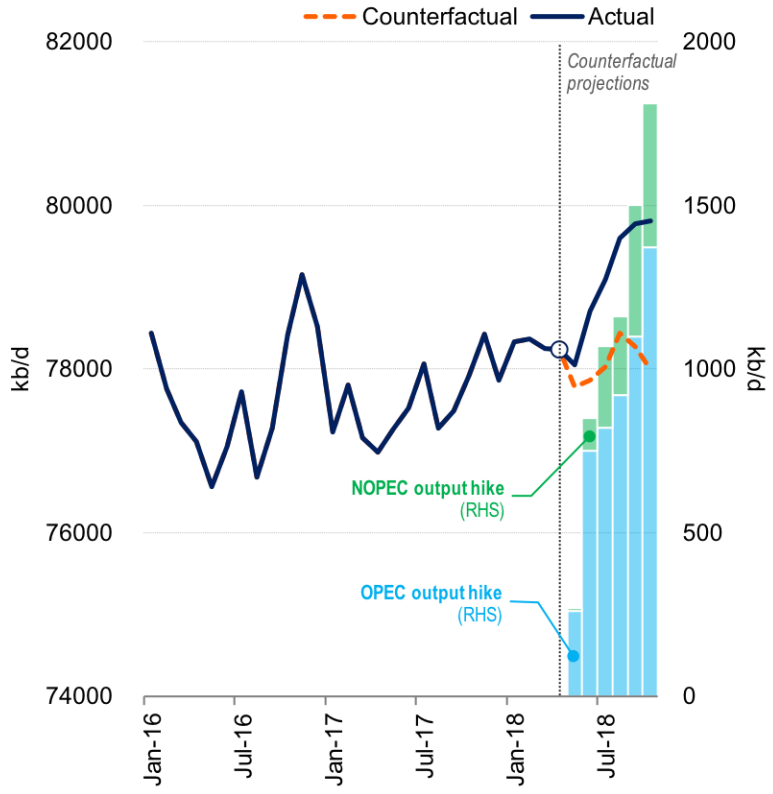


As the next OPEC Meeting approaches, oil exporters are now signalling that they may have to implement large output cuts in 2019, as the sense of "Mission Accomplished" after their June meeting has gradually faded in recent months. Prices falling and OECD stocks returning above their 5-year average are generating concerns about the prospects of the oil market.

Data: IEA, OIES

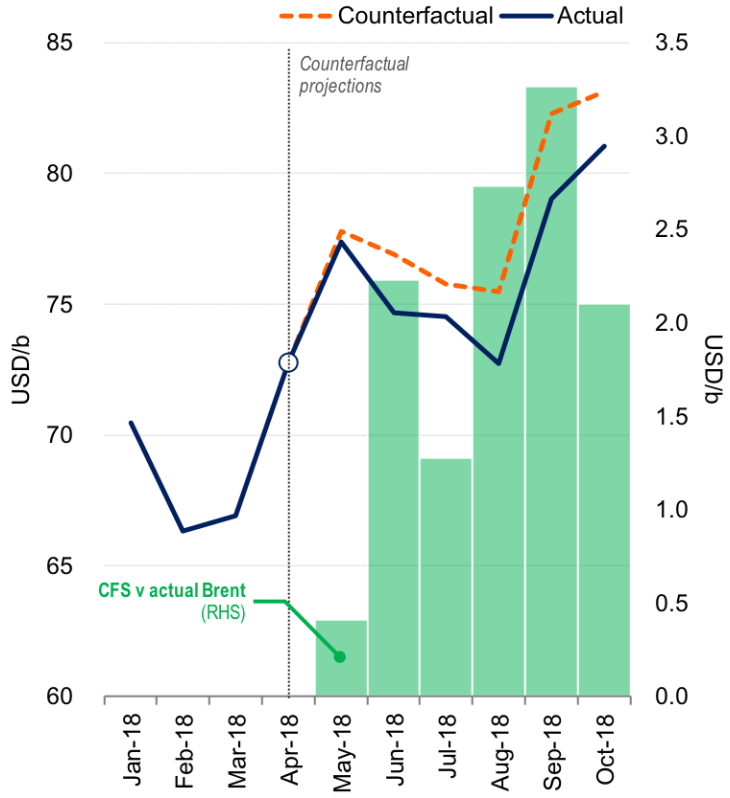
What-if OPEC stood by its pledged output targets?

World crude oil production w/ and w/out OPEC+ output hike as of May 18, Jan 16 – Oct 18



Had Saudi Arabia, Russia and other oil exporters that are capable of increasing output not increased output since May 2018, in October global oil production would have been lower by 1.8 mb/d.

Brent price evolution w/ and w/out OPEC+ output hike as of Apr 18, Jan 18 – Oct 18

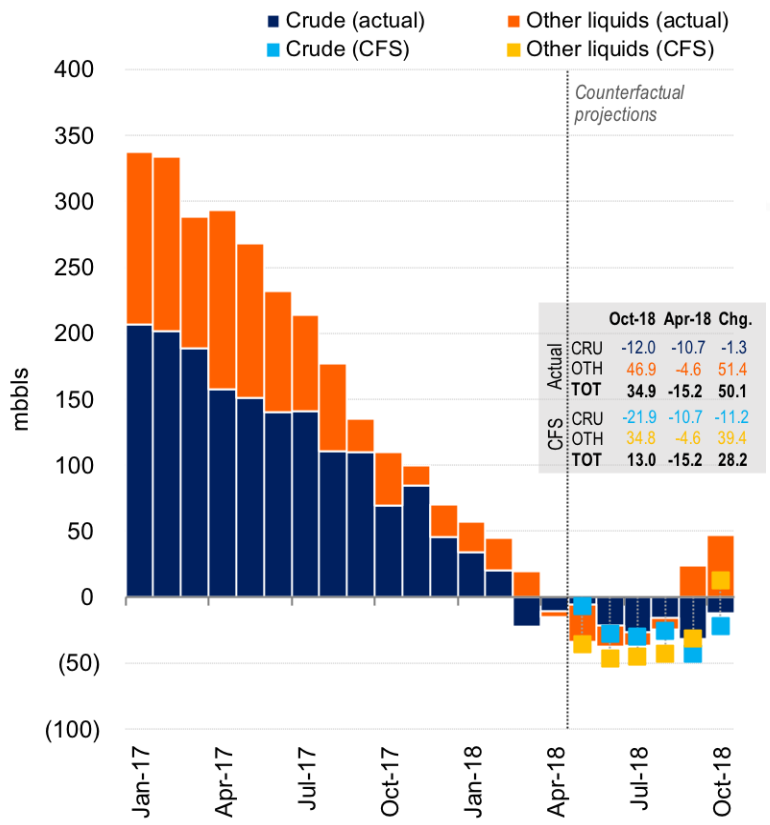


But even with this lower level of production, oil prices would have only averaged about $2/b higher than the actual observed, implying that most of the September/October price increase was driven by expectations of a supply shortage due to the potential of large Iranian losses.

Data: IEA, OIES

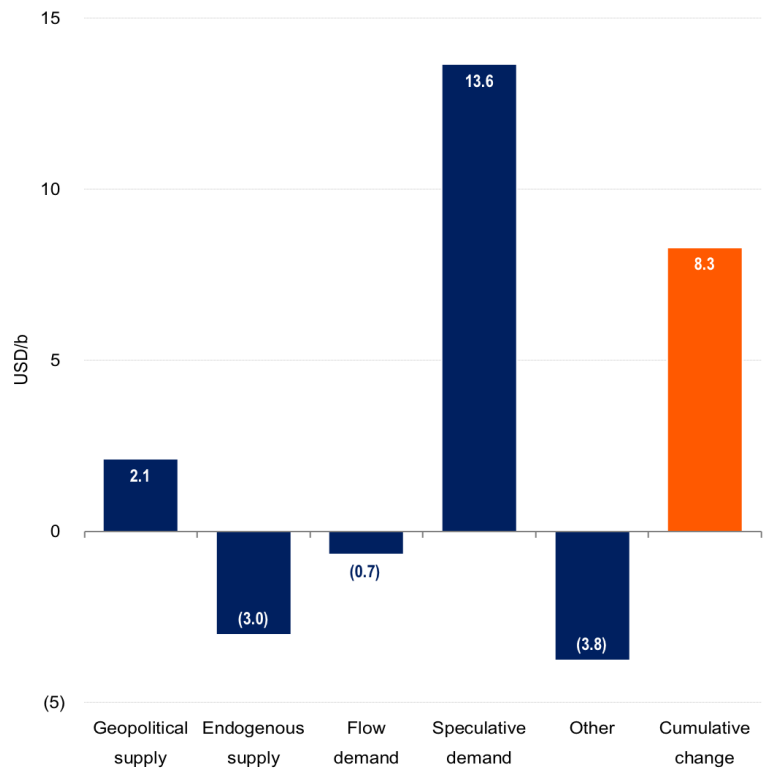
Shift in fundamentals or expectations?

OECD stocks v. 5-year average w/ and w/out OPEC+ output hike as of May 18, Jan 17 – Oct 18



Even without the OPEC+ output hike, OECD stocks would have still risen above their 5-yr average but the pace of stock build-up would have been slower and only half the actual observed.

Contribution of oil supply and demand shocks to the Brent price increase in Sep/Oct 2018



Changes in supply-demand fundamentals contributed little to the September/October price increase. Speculative demand shocks driven by shifts in expectations accounted for the bulk of the price increase (+14/b). Thus, any revisions in these expectations would have resulted in a sharp fall in oil prices.

Data: OIES

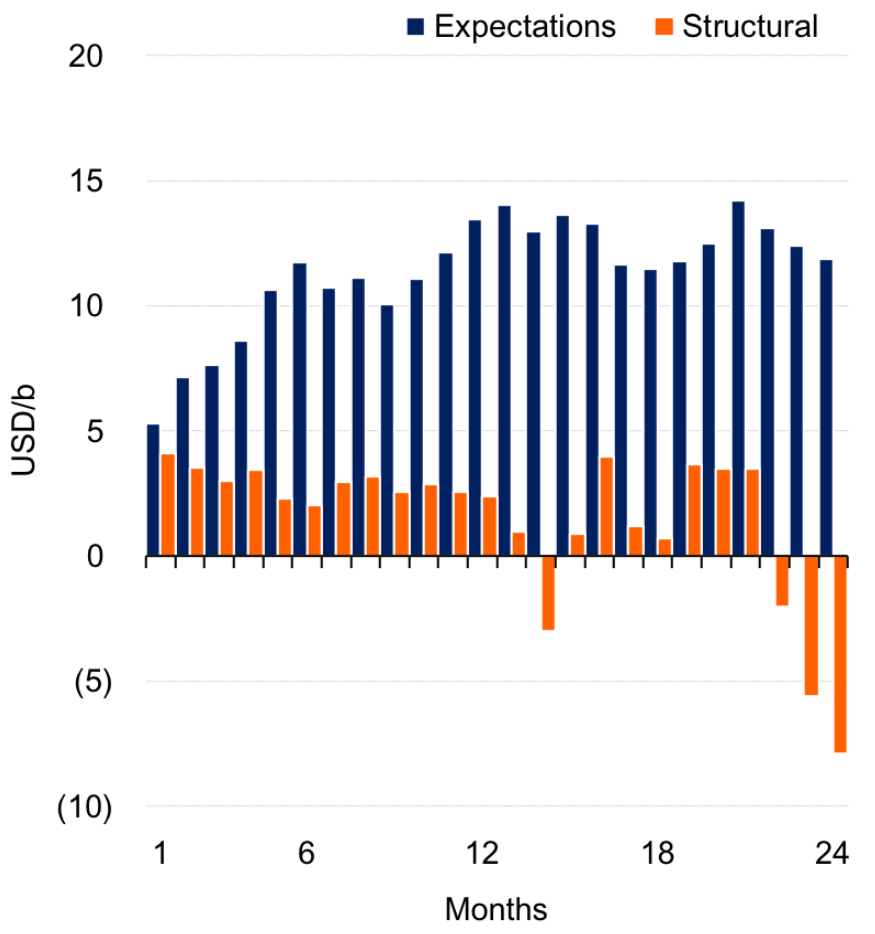
OPEC hard choices

The market fundamentals perspective

- Looking ahead, OPEC faces very hard choices and is subject to important constraints.
- If the recent decline in oil price is driven by structural shifts in supply-demand fundamentals and are of permanent nature, then Saudi Arabia may be reluctant to cut oil output.
- If the recent decline in the oil price is driven by speculative demand, associated with a large build-up in stocks in anticipation of a price increase due to the Iranian sanctions, and a deterioration of these expectations, then Saudi Arabia will be more susceptible to cuts to stabilise market expectations and reduce the stock-build.
- If Saudi Arabia where to cut its output back to April 2018 levels (i.e. by -0.73 m/d from October level) and the current shift in price dynamics is driven by expectations and not supply-demand dynamics, then oil price gains could be maintained within the $70/b and $80/b range.
- If however the current shift in price dynamics is structurally driven by higher-than-expected OPEC and non-OPEC output and a slowdown of global demand growth, the price gains will be small and short-lived.

So how Saudi Arabia perceives the shock will be one of the key determinants of its output decision next week; but not the only one.

Oil price response to a KSA output cut in the face of structural shifts in fundamentals v. expectations



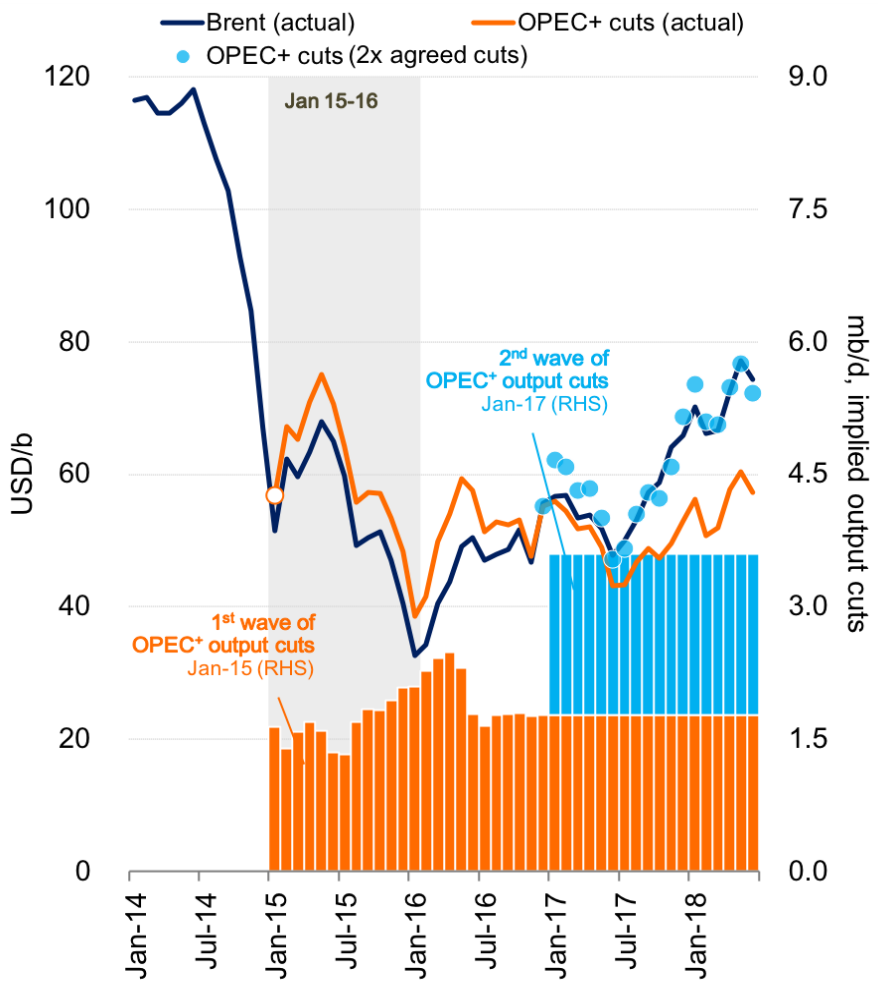
Data: OIES

Deja-vu … but not quite

- If the current price drop is perceived as driven by structural changes in supply-demand fundamentals, Saudi Arabia may be facing the same hard choices as it did back in November 2014.
- But this time around it faces more constraints which may limit its output policy flexibility.
- Unlike in 2014 when Saudi Arabia decided not to cut output in the face of structural shifts in market fundamentals (slowdown in demand growth, rise in US shale production, and the return of 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 needs a higher oil price.
- The political backdrop both domestically and internationally has also 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; or it may decide to cut output even if it believes the shock is more permanent.

Brent price outcomes as of January 2015 w/ and w/out OPEC+ output cuts, Jan 14 – Jun 18



Data: OIES

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