OPEC Choices are Getting Harder and Harder

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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?

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?

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.

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.

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.

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

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.
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 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.
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.