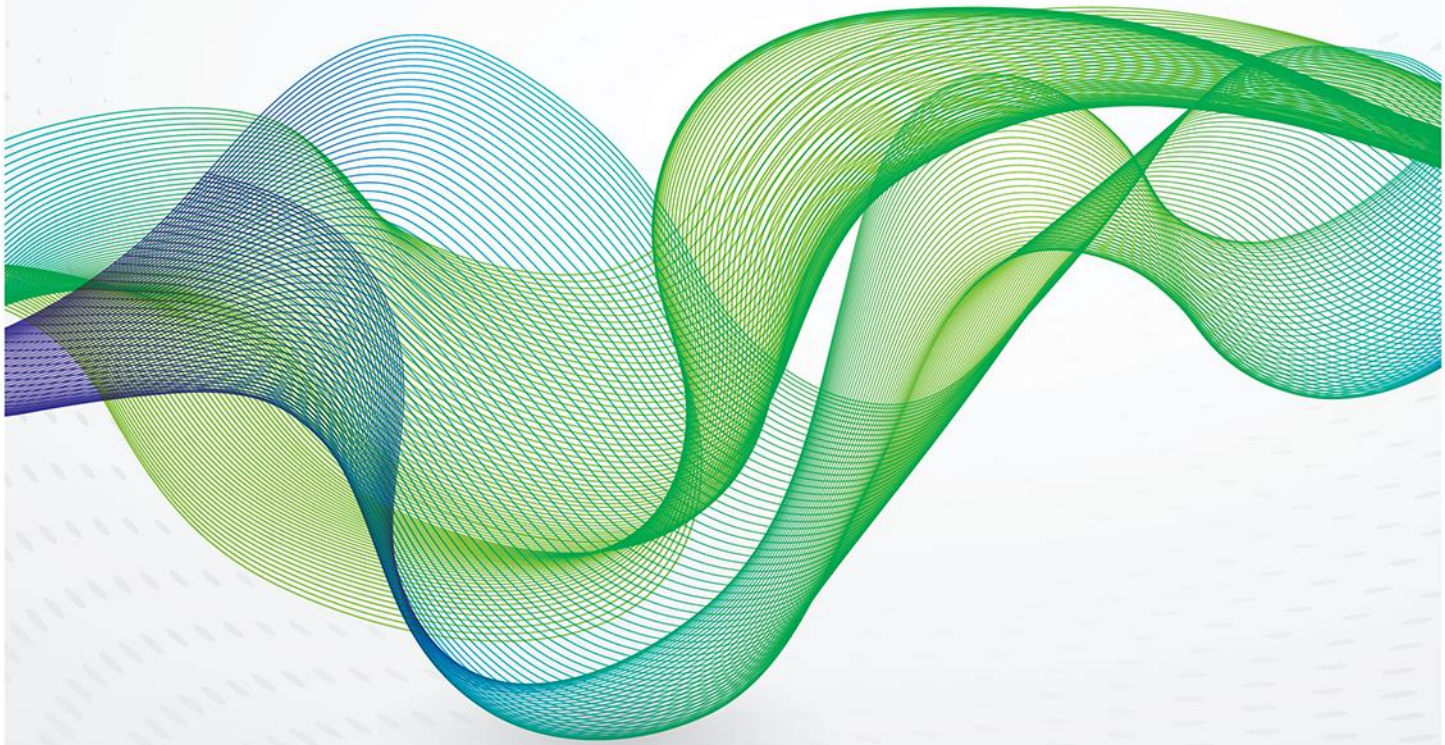
THE OXFORD INSTITUTE FOR ENERGY STUDIES

May 2019

Has Saudi Arabia's Balancing Act Gotten Any Easier?



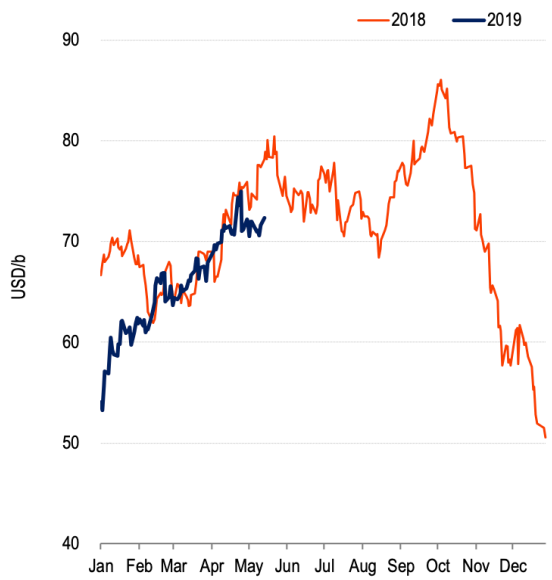
OXFORD ENERGY COMMENT

Bassam Fattouh and Andreas Economou

1. Mixed Signals

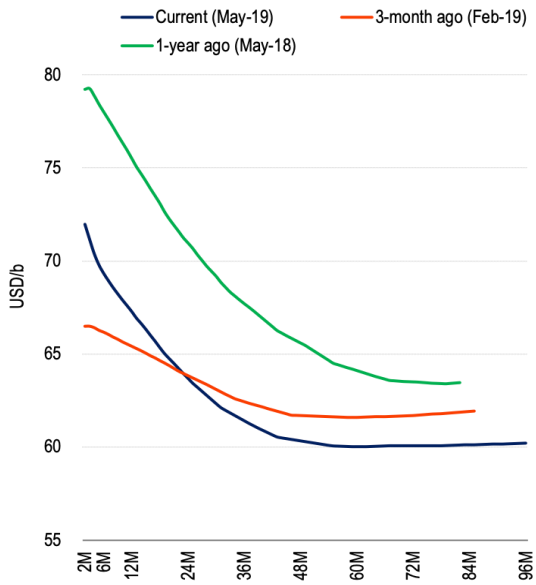
The recent movements in the oil price complex indicate some deep dislocations between the physical and futures markets and in market expectations about current and future oil market fundamentals. Despite the various supply shocks hitting the oil market, the general deterioration in the geopolitical backdrop and the rise in US-Iran tensions[1], the Brent price has continued to trade within a very narrow price range of between $70/b-$75/b since early April 2019 and price volatility has remained subdued (see Figure 1). The price at the back end of the futures curve has so far failed to break away from the $60-65/b price range (see Figure 2).

Figure 1: Daily Brent price, Jan 18 – May 19



Source: EIA, OIES.

Figure 2: ICE Brent forward curves, 20 May 19



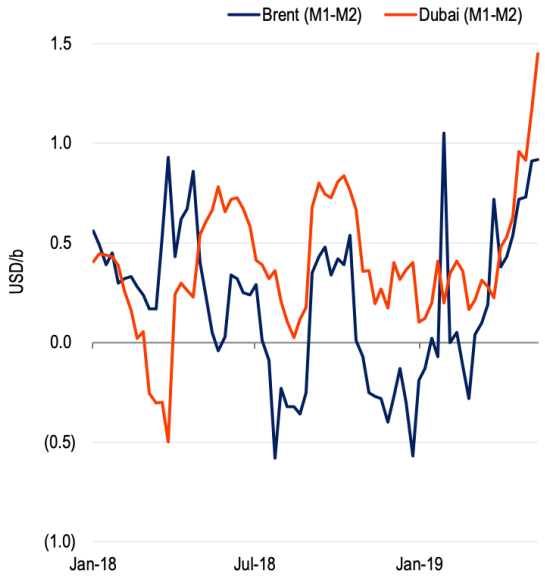
Source: ICE, OIES.

In contrast, time spreads are pointing towards very tight market conditions, with Brent and Dubai time spreads in steep backwardation (see Figure 3). Furthermore, the deep cuts by Saudi Arabia since December 2018 and the output losses from Iran and Venezuela, and more recently Russia, are providing support for physical differentials, with medium-sour crudes such as Urals and Dubai trading strongly relative to Brent (see Figure 4). OECD stocks fell 2.2 mbbls below their five-year average in March 2019, down by about 50.0 mbbls from December 2018.

In fact, the oil market finds itself in an almost opposite position to the same time last year when futures prices rose sharply in the expectation that market fundamentals would tighten, while the time spreads and physical differentials were pointing towards a well-supplied market.[2] The divergence was eventually resolved in the second half of 2018 by flat prices falling sharply as Saudi Arabia, UAE, Kuwait and Russia increased output, US shale production surprised on the upside, and the US granted sanction waivers on Iranian oil exports, reversing expectations about the size of Iranian output losses and reducing precautionary demand.[3]

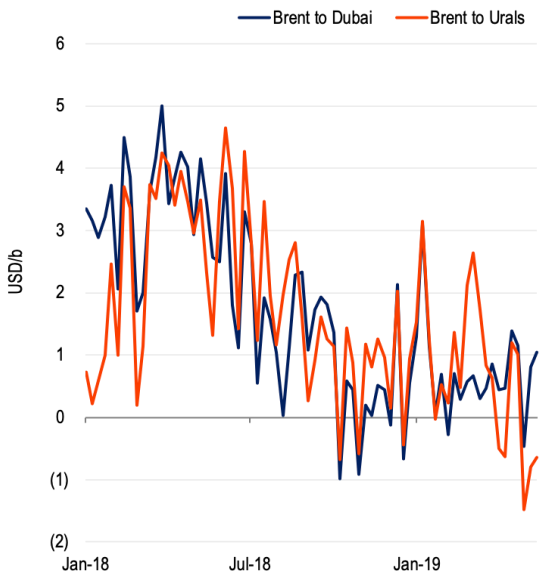
[1] Bloomberg (2019), 'Persian Gulf Now Most Risky for Oil Tankers Since Last Iraq War', 21 May 2019.
[2] See Fattouh, B. (2018), 'The Oil Market's Mixed Price Signals', Oxford Energy Comment, Oxford: OIES, May.
[3] See Fattouh, B. and Economou, A. (2018), 'OPEC Choices are Getting Harder and Harder', https://www.oxfordenergy.org/wpcms/wp-content/uploads/2018/11/OPEC-Choices-are-Getting-Harder-and-Harder.pdf Oxford: OIES, November.

Figure 3: Time spreads, Jan 18 – May 19



Source: Argus, OIES.

Figure 4: Crude spreads, Jan 18 – May 19



Source: Argus, OIES.

Looking ahead into the second half of 2019, the oil market faces the key issue of how this divergence in expectations and the mixed signals from the physical and futures markets will eventually be resolved. If 2018 is a good guide, the price level will eventually increase to reflect the current tightness in the physical market. In a way, this underlines the current bullish view that oil is 'about to see a violent price spike'.[4] Deep cuts from Saudi Arabia and supply disruptions from Iran and Venezuela saw OPEC output reach low levels of 30.2 mb/d in April 2019 (down from 32.3 mb/d in November 2018); contamination of the Druzhba pipeline is causing a decline in delivered crude from Russia[5]; deterioration in the geopolitical backdrop is increasing the risk of further output disruptions from Iran, Venezuela, and Libya; and the decline in rig activity and a slowdown in US shale production growth all point to a tighter supply picture. The IEA's warning that investment levels are falling short of what will be needed to meet global oil demand only provides further support for this thesis.[6]

2. Timing is key

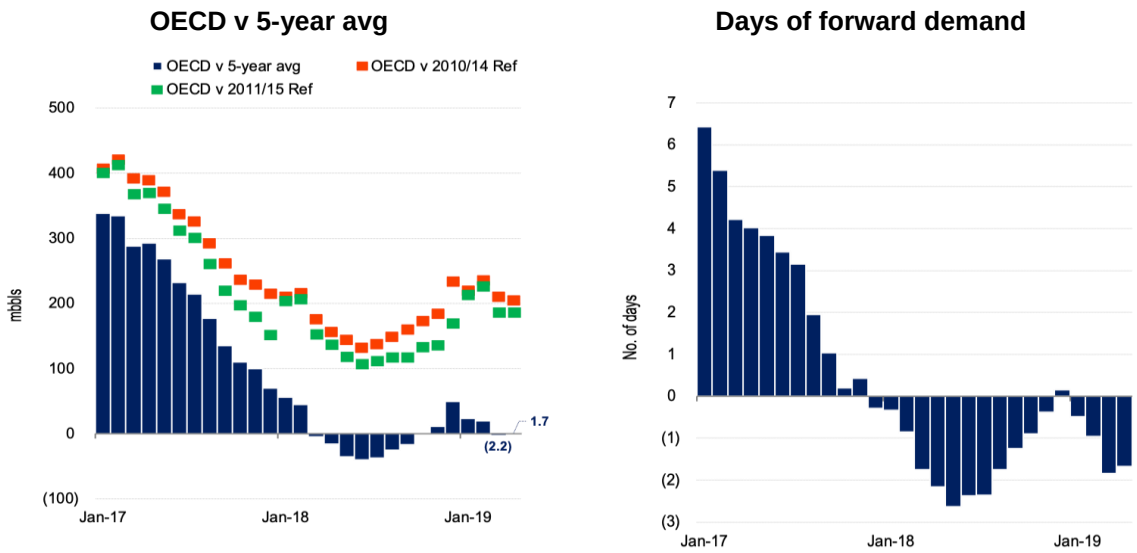
The recent signals from OPEC, and its key player Saudi Arabia, that the task of rebalancing the market is not yet complete as inventories keep rising and the market is well supplied may have come as a surprise to many.[7] It reinforces somewhat the bullish view that OPEC+ will behave differently this time round and will not take 'pre-emptive' action to increase output before 'shortages' are actually realised. OPEC's 'cautious' approach has its merits but also its risks. As argued in Fattouh and Economou (2019), 'although Saudi Arabia is in a better position to manage the market compared to 2018, this does not mean that there are no risks of under-supply (for instance, if Saudi Arabia adopts the wait and see approach until Iran losses are realised) or over-supply (if prices run ahead of

[4] Rystad Energy (2019), 'Tight Oil Markets Could Be About To See A 'Violent' Price Spike', https://oilprice.com/Energy/Energy-General/Tight-Oil-Markets-Could-Be-About-To-See-A-Violent-Price-Spike.html, May 13.
[5] Yermakov, V. (2019), 'The Domino Effect: contaminated oil in the Druzhba oil pipeline – implications of the incident for Russia and Europe', Oxford Energy Comment, Oxford: OIES, May.
[6] IEA (2019), World Energy Investments 2019, Paris: IEA.
[7] Reuters (2019), 'Saudi's Falih says sees no oil shortage, but OPEC to act if needed', May 18.

fundamentals and under US pressure, the Saudis increase output sharply to try to control the oil price)'.[8]

Thus, timing is key and in an environment of heightened uncertainty, the option to delay the decision on whether to change the current course (for instance until the next OPEC meeting in June or July) has intrinsic value for Saudi Arabia. The challenge though is that rather than being resolved, most of the uncertainties (both on the supply and demand side) will only intensify in coming months. The reliance on the indicator of OECD stocks relative to its five-year average as a guide to output policy is of limited use, not least because it is a backward-looking indicator whereas an effective output policy should be based on forward-looking indicators and a view of how market fundamentals are most likely to evolve. The discussion of changing the metrics of calculating excess inventories (for example, using 2010-14 or 2011-15 as a reference point, see Figure 5) does not alter this and the choice of the metrics will be shaped in large part by the desire of OPEC+ to relax or not relax its supply cuts.[9]

Figure 5: OECD commercial stocks, Jan 17 – Apr 19E



Notes: April estimates are based on preliminary data from the US, Japan and the EU(16). Days of forward demand are calculated using actual demand except in April 2019 when the latest IEA forecasts are used.
Source: IEA, OIES.

In this respect, Saudi Arabia finds itself in a very similar position to last year where it has to make some hard choices and play a balancing act to try to achieve multiple objectives: Not risk pushing the market out of balance causing oil prices to fall, while at the same time preventing prices from getting too high and harming consuming countries and oil demand. Pressures from Russia to ease the supply curb and from the US to keep prices lower are not very different from last year's, perhaps with one major difference, President Trump may be willing to live with slightly higher oil prices, recognizing that in a low oil price environment, US shale production growth would stall and that his key allies in the Middle East need a higher oil price to maintain government spending. Saudi Arabia would also be sensitive to the dynamics within OPEC+, aiming towards maintaining the deal that it has engineered and reinforcing the message that Saudi Arabia's oil policy is driven purely by market fundamentals. Saudi Arabia's deep cuts since December 2018, with current output at levels below its agreed quota,

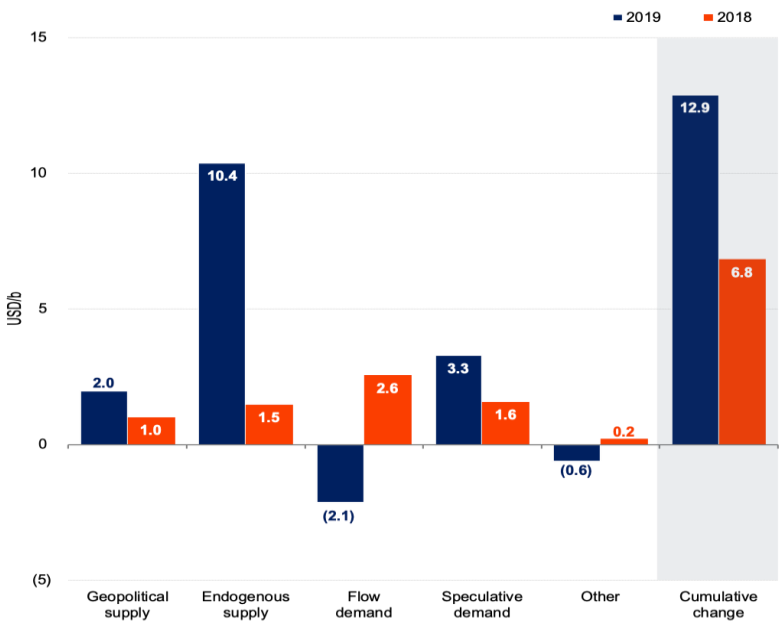
[8] Fattouh, B. and Economou, A. (2019), 'Iranian Sanctions 2.0: Oil Market Risks and Price Stakes', Oxford Energy Comment, Oxford: OIES, April.
[9] Seeking Alpha (2019),'OPEC Insights: Jeddah Mind Tricks at OPEC's Meeting', May 20.

gives the Kingdom some flexibility to increase output by around 0.5 mb/d without exiting the deal. The Saudi Energy Minister, Mr. Al-Falih, is quite confident that OPEC+ 'will strike the right balance'.[10]

3. The balancing act does not get any easier

As in 2018, however, this balancing act is hard to maintain given the wide uncertainties engulfing the market and the divergent interests of the different players. One such uncertainty relates to the prospects of demand. As Figure 6 shows, the contribution of demand to the oil price rise has, so far, been disappointing. Weaker-than-expected demand, especially in the first quarter of 2019, kept prices lower by $2/b, when at the same period last year strong demand accounted for 40 per cent of the price increase. While the outlook for the second half of the year is optimistic, in part as IMO2020 comes into effect, the current fragility on the demand side remains a major concern. There has been a shift in expectations about the prospects of the global economy in recent weeks, with the escalation of the US-China trade war expected to negatively impact global growth, though views about the size of any potential impact are very wide. Hedge funds have recently been liquidating some of their bullish positions as concerns about the global economy intensify.[11] While China's crude oil imports are at a record level of above 10.64 mb/d in April 2019, part of this demand increase is for precautionary purposes as the risk of losses from Iran and Venezuela continues to increase. In addition, although a deteriorating geopolitical backdrop increases risks to oil supplies and thus is a supportive factor, it is important not to discount its dampening effect on economic growth, especially if it results in higher and more volatile oil prices.

Figure 6: Brent price drivers, Jan – Apr 2018/19



Source: OIES.

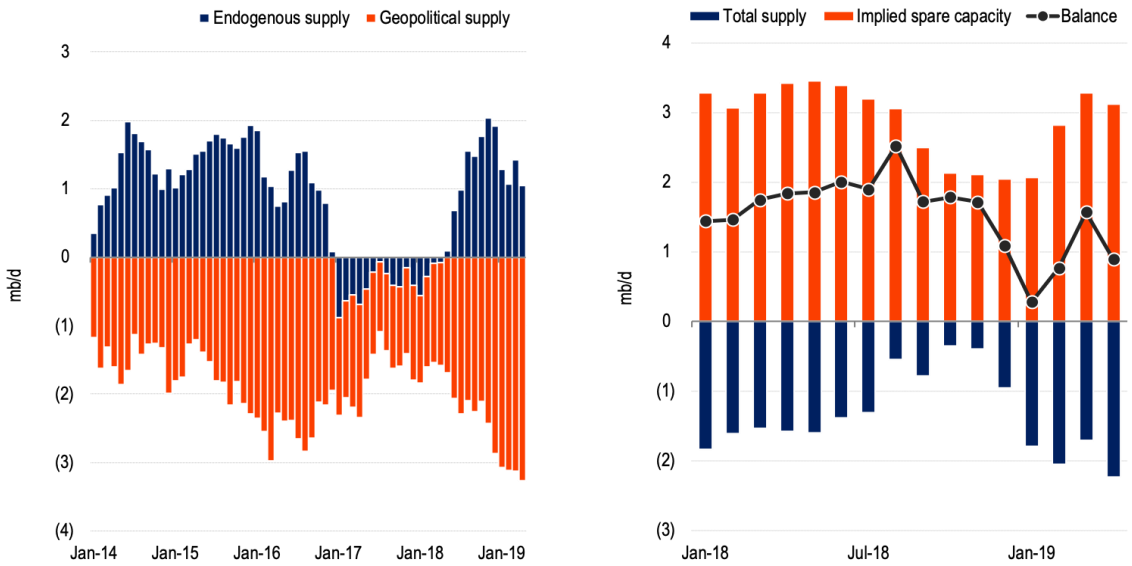
On the supply side, the situation is also unclear (see Figure 7). On the one hand, the OPEC+ policy reversal in mid-2018 and the production hikes that followed, in conjunction with the strongest year on record of US shale production growth led to a build in inventories. And while this time round Saudi Arabia and the other OPEC+ producers have set their collective output cut target 0.6 mb/d lower than

[10] Reuters (2019), 'Saudi's Falih says sees no oil shortage, but OPEC to act if needed', May 18.

[11] Kemp, J. (2019) 'Funds sell oil as economic fears trump supply threats', Reuters, May 20.

they did in November 2016, excluding geopolitical disruptions the supply overhang in the second half of 2018 had been 0.6 mb/d higher than it was two years ago (at 1.62 mb/d compared to 1.01 mb/d). That said, geopolitical outages have reached multi-year highs exceeding 3.0 mb/d, pressuring prices and clouding a clear future policy path, especially as in this environment speculative demand pressures tend to play a bigger role in shaping prices. And although the core GCC have the spare capacity to offset these losses and keep the market well supplied (see Balance on the RHS of Figure 7), eliminating the spare capacity cushion will leave prices, consumers, and producers, all the more vulnerable to abrupt shocks.

Figure 7: Global supply balances, Jan 14 – Apr 19



Source: OIES.

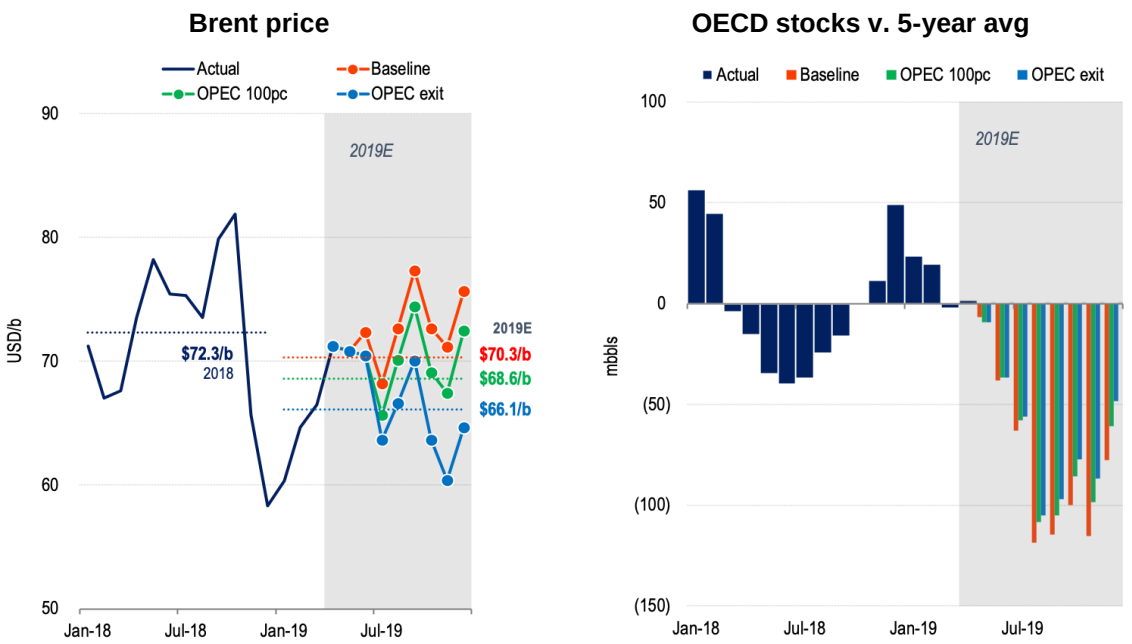
The forecast scenarios shown in Figure 8, lay out the three principal options that OPEC and Saudi Arabia are currently facing:

1. Maintain the current level of overcompliance for the remainder of the year (no-change from current policy); referred to as the *baseline scenario*.
2. Eliminate overcompliance from June 2019 onwards, returning 0.45 mb/d of withheld production back into the market without altering the agreement and maintaining the agreed output cuts at 100% compliance for the remainder of the year; referred to as the *OPEC 100pc scenario*.
3. Return all the withheld supplies under the December 2018 agreement back into the market, where possible, in accordance to the allocated baseline supply targets, emulating the production increases in the second half of 2018 (essentially following a pre-emptive policy) and resulting in a total of 1.64 mb/d of increased production; referred to as the *OPEC exit scenario*.

All scenarios assume that production from Iran and Venezuela declines to 2.0 mb/d and 0.6 mb/d ending-2019; the global economy in 2019 grows by 3.3 per cent; US shale production grows by 1.1 mb/d; and incremental demand rises gradually by 0.3 mb/d in the final quarter of 2019, in anticipation of the enforcement of the IMO2020 ruling. As can be seen in Figure 8, if Saudi Arabia and the rest of the producers maintain the current levels of overcompliance, prices are expected to average $5.3/b higher in the second half of 2019 compared to the first (largely due to the geopolitical disruptions), reaching, on a monthly basis, as high as $77/b, all else remaining equal. Should they choose to eliminate overcompliance however, the aforementioned gains in the second half of the year will be halved to $2.5/b and prices are projected to remain at around $70/b. Lastly, if the producers decide to exit the agreement and ramp up production in a similar fashion to 2018, then prices are expected to

fall towards the low $60/b and prices in the second half of the year to retreat by $2.5/b on average relative to the first half of the year. Ending-2019, the cost of a hasty exit from the output cut agreement may reach $8/b on a monthly basis, compared to the more cautious approach of eliminating overcompliance (i.e. OPEC 100pc scenario).

Figure 8: OPEC+ choices forecast scenarios as of May 2019, Jan 18 – Dec 19E

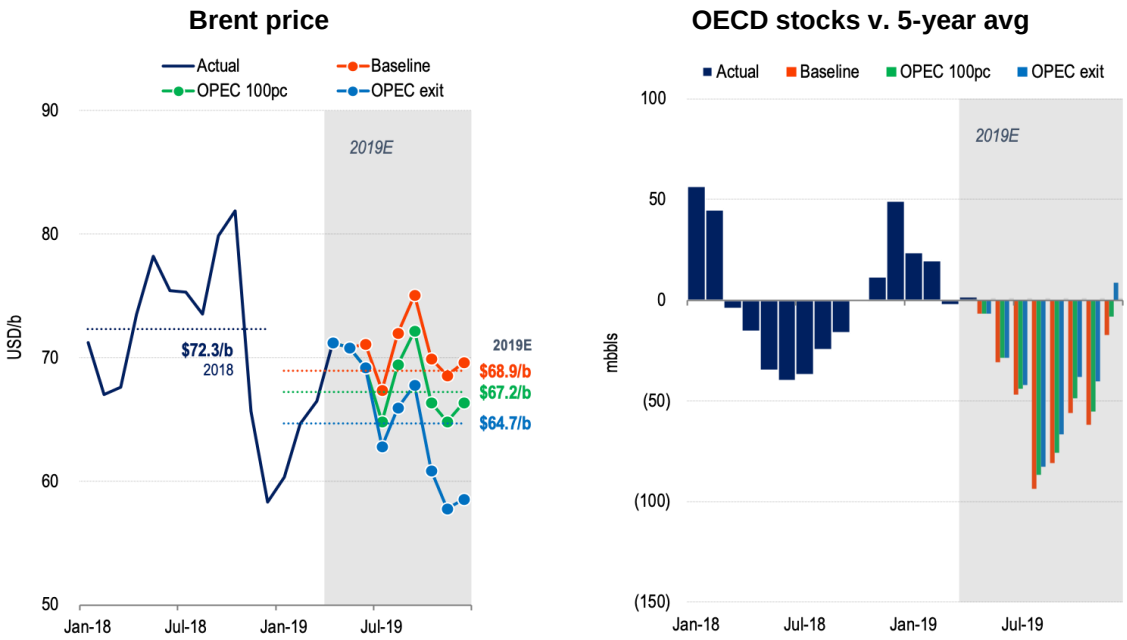


Source: OIES.

The decision that Saudi Arabia eventually adopts depends on its view on the supply-demand outlook and the scenario it thinks will most likely play out. The 14th Joint Ministerial Monitoring Committee (JMMC) meeting in Jeddah on May 19, 2019, revealed some of these views: the market is not suffering from shortage, supplies are abundant, OPEC will not be fooled by $70 prices, fears of disruption should not be exaggerated, and critical uncertainties remain on the demand side due to factors such as on-going trade negotiations and monetary policy. It is the latter view pertaining to an unexpected slowdown of the global economy (and hence global demand) that is of major concern. To illustrate this point, Figure 9 incorporates in all the above forecasts a negative demand shock resembling a weaker-than-expected growth of the global economy in the second half of 2019 based on which annual growth is revised downwards by 0.1% from the baseline assumption, to 3.2%. Under the more cautious approach of eliminating overcompliance (i.e. *OPEC 100pc scenario*), Saudi Arabia will be able to manage and keep prices within the $65/b and $70/b range. Whereas, if the premature return of the withheld supplies back into the market is confronted by an unexpected slowdown of global demand (i.e. *OPEC exit scenario*), the prices are expected to take a hit and fall to the $50/b range, similar to the last quarter of 2018, and stocks are expected to swiftly revert above their five-year average by 8.6 mbbls year-end.

Their view of the future evolution of market fundamentals however is not the only factor affecting Saudi oil output policy. Saudi Arabia's decision will also be determined by certain preferences: the desire to keep prices at healthy levels and to maintain the December 2018 OPEC+ deal for as long as possible 'to keep inventories on their way declining gradually, softly but certainly declining towards normal levels'. But Saudi Arabia also faces constraints, as it has to take into account the preferences of its allies (US and Russia) and the impact of its policies on supply-demand dynamics and oil prices. It is the interplay of all these factors, which will shape the price path for the rest of this year.

Figure 9: Economic downturn forecast scenarios as of May 2019, Jan 18 – Dec 19E



Source: OIES.

4. Conclusion

The relative price stability in the last few months largely reflects the perception that Saudi Arabia is managing this balancing act fairly well and that the events of the second half of 2018 will not be repeated. The bulls are betting that Saudi Arabia will take a 'firm' approach, keeping its current stance of tightening output and that they will not increase output pre-emptively. The bears, on the other hand, are of the view that 'political' constraints will push Saudi Arabia to increase output sooner or later and if the timing is wrong, this will push the market out of balance yet again. The events of the second half of 2018 are still fresh in the mind,[12] and while it is very convenient to box market views into these distinct categories, historical experience shows the oil market rarely generates 'neat' outcomes. The extent of dislocations in expectations and the challenge of navigating in the current foggy conditions indicate that the oil market is set for a very bumpy ride.

[12] Bloomberg (2019), 'Saudis Talk Tough at OPEC+, But Oil Market Remembers 2018 U-Turn', 20 May.