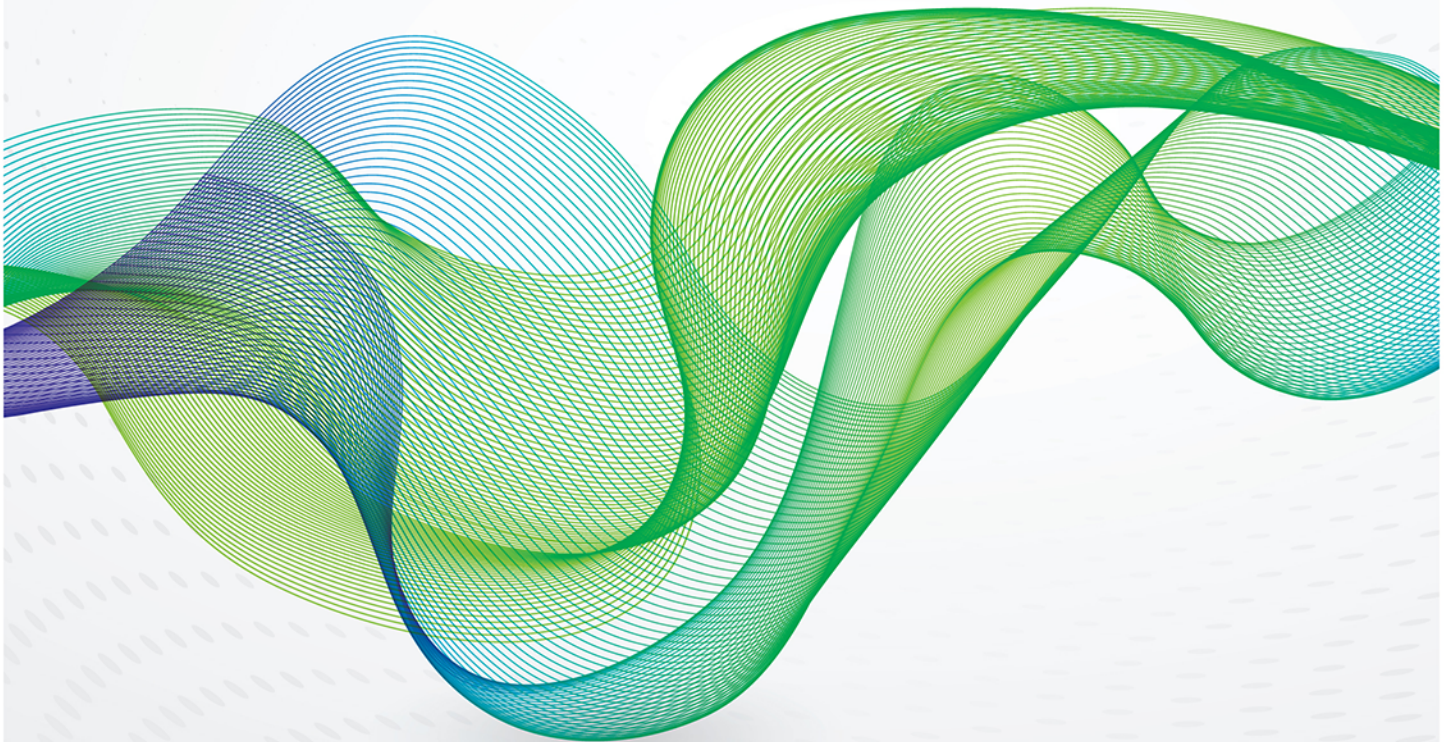




THE OXFORD
INSTITUTE
FOR ENERGY
STUDIES

November 2020

Oil Market Recovery and the Balance of Risks

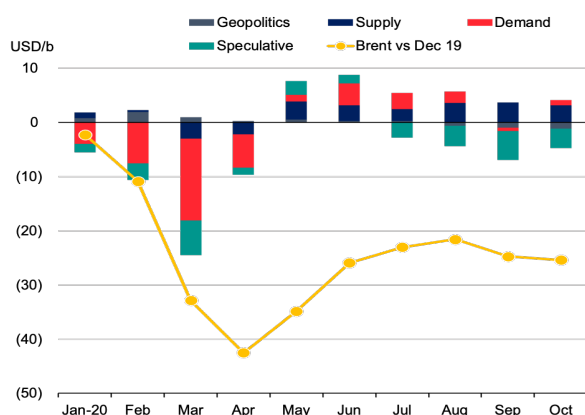


OXFORD ENERGY COMMENT

Bassam Fattouh and Andreas Economou

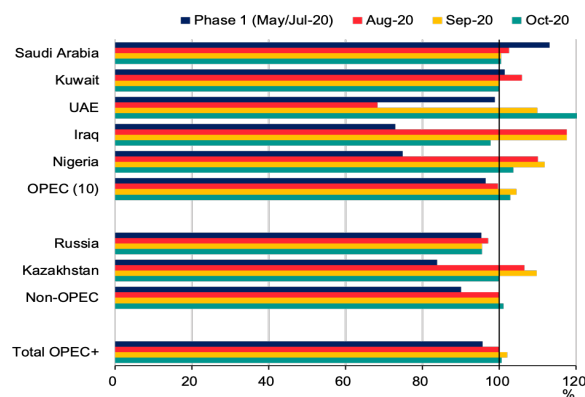
After achieving month-on-month gains in every month between May and August, the Brent price shed some of these gains in September and October with the monthly Brent price falling by \$3.8/b between August (\$44.3/b) and October (\$40.5/b). While the slow and uneven pace of oil demand recovery still constitutes the main headwind facing the oil market, the downside risks from the supply side have been on the rise in the last few weeks. The shift in focus towards supply risks is a key dynamic as most of the recent oil price support has originated from the supply side of the equation (Figure 1). Particularly, the size of the OPEC+ cuts and the high OPEC+ compliance close to 100% have been key reasons why the oil price absorbed weak demand and kept Brent supported above \$40/b (Figure 2).

Figure 1: Oil price drivers



Source: OIES.

Figure 2: OPEC+ output compliance



Source: IEA, OIES.

But additional supply is now undermining the balancing narrative. First, there has been the return of Libya's barrels to the market. According to Libya's NOC, production as of November 7 returned above 1 mb/d.¹ In Canada, the Alberta government has announced that it will stop setting monthly oil production limits for producers by December 2020. At the start of the pandemic, more than 20% of Alberta's oil production went off-line. Most of the shut-in production in Canada and the US during April and May has already made its way back to the market. In the background, the next move by OPEC+ at the end of November is still casting uncertainty over the market. The OPEC+ agreement brokered in April called for the release of an additional 2 mb/d from January 2021. With the recent flow of poor demand data, and tighter lockdowns in many parts of the world, a delay in tapering the current cut has now become the base case expectation for most market participants.

OPEC+ next move and Saudi-Russia relations

This focus is bringing to the fore yet again the state of Russia-Saudi oil relations, and whether the two countries could compromise to tweak the current agreement and more generally, on whether they are able to cooperate for an extended period and in different market conditions. Russia-Saudi relations are informed by two key aspects.

First, the break-up of the OPEC+ agreement in March was certainly a key event in this cycle, and many consider it to have weakened the relations between the two producers. However, all the evidence points to the contrary and this should not come as a surprise. The disagreement between OPEC and Russia in March 2020 was not about the core principle that in face of a shock such as COVID-19, the fastest and most effective way to balance the market was for producers to act collectively and cut output. All producers agreed on this general principle. Relying on price mechanisms to clear the market imbalance would have been a lengthy and protracted process. Instead, back in March, there was uncertainty about the scale of the shock and hence the timing and the required size of response. While Russia was of the view that producers should wait until more information about the impact of COVID-19 was revealed,

¹ Argus (2020), 'Production recovery faces infrastructure, stability tests', Petroleum Argus, November 13.

Saudi Arabia was of the view that it was important to act pre-emptively and proactively. But unlike previous price cycles such as in 1997-1998 and in 2014-2016, when it took many months and even years to reach an agreement, Russia and Saudi Arabia were able to get together and agree on one of the deepest output cuts in the history of the oil market.

The second aspect relates to the 'trigger price' for Russia's exit from the OPEC+ agreement. Russia has always given the impression that its trigger price for an exit from the agreement is in the \$50/b-\$55/b range. In contrast, Saudi Arabia is believed to have a much higher preferred price and it would be worse off from exiting the deal at the \$50/b-\$55/b price range. However, there are few qualifications to be made:

- First, it is important to stress that the current agreement extends to April 2022. There is potential to tweak the agreement if participating countries feel this is needed. There is no reason why OPEC+ can't agree on these tweaks. In fact, President Putin announced that while he thinks there is no need to change the agreement, he doesn't rule out 'that OPEC+ may keep the current restrictions on output'.² He went further to say that 'if necessary, OPEC+ can take a decision on further cuts', but added that so far he sees no such need as the market remains fairly balanced.
- Second, the price recovery is likely to be gradual and capped by sizeable buffers such as high crude and product stocks, significant spare production capacity and the potential return of disrupted barrels, so an exit decision is not looming any time soon.
- Third, Saudi Arabia may not be the ultimate loser from such an exit if it occurs prematurely. As the events back in March show, Saudi Arabia has the capacity to compete on volumes if it has to, and the increase in revenues due to higher volumes will compensate at least partially for the decline in oil price due to higher supply. This is especially the case if non-OPEC supply, particularly US shale oil, is not able to increase supply in the current price environment.
- Finally, the Saudi economy is not as weak as some in the media tend to portray. The Kingdom's public finances have been adjusting to lower prices by cutting spending and introducing new sources of non-oil revenue. Also, Saudi Arabia has introduced many reforms including fiscal, labor market and energy pricing reforms during the 'good times', which has improved the Kingdom's resilience amid the current price shock. Of course, these remain very challenging times for the Kingdom and in its 2021 Preliminary Budget Statement, the Ministry of Finance now expects the fiscal deficit to hit SR 298 billion (12 percent of GDP), compared to SR187 billion (6.4 percent of GDP) previously. However, Saudi Arabia has fiscal buffers and has access to international debt markets and in the pre-budget statement, the expectation remains for the deficit to progressively narrow to less than 1 percent by 2023 (Jadwa Investment assumes this could be achieved with an oil price of \$55/b).³

These factors contribute to the stability of Saudi-Russia oil relations and so far, all indications are that the two countries can adjust the deal to changing market conditions and achieve an orderly exit from the current agreement at the appropriate time.

The shadow of Iran

The shifts in supply dynamics are causing market participants to look further ahead to the return of more disrupted supplies, particularly from Iran and Venezuela. While Venezuela's potential is quite limited given the damage to its infrastructure over the last few years⁴ the picture for Iran is fundamentally different, not only given the potential increase in the size of its exports, but also the impact that the return of Iran may have on OPEC+ dynamics. There is a general belief with Biden now having won the election, that the US will return to the Joint Comprehensive Plan of Action (JCPOA) in a short period of time. This would mean the return of 1.2-1.4 mb/d as soon as 2021 (Iran's exports have risen considerably both in September and October defying US sanctions and as such Iran's production

² Bloomberg (2020), 'Putin says Russia open to delaying planned OPEC+ output hike', October 22.

³ Jadwa Investment (2020), '2021 Preliminary Budget Statement', October.

⁴ Fattouh, B. and A. Economou (2020), 'Oil Market Recovery Under Pressure', OIES Presentation, November 9. Available at <https://www.oxfordenergy.org/publications/oil-market-recovery-under-pressure/>

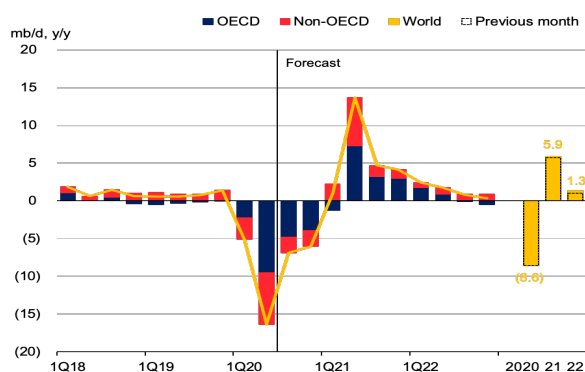
numbers are likely to be higher than being reported) .⁵ This scenario is being increasingly incorporated into the 2021 and 2022 balances and may add to the bearish sentiment.

However, such an optimistic view on the fast return of Iran needs to be tempered for a number of reasons and this is not related to technical issues. Iran has plenty of oil in storage and Iran's NIOC has kept up with maintenance at its oil fields since 2018 and it is confident that production could be ramped back up to pre-sanctions levels within few months. One reason why the fast return of Iranian barrels may not materialise is that negotiations to reach a final agreement may take longer than expected and the delays are likely to come from the Iranian side. The Biden administration may want to change some elements of the JCPOA. Such calls will face resistance from Iran. An 'emboldened' Iran may not want to give the impression that it is desperate for a deal. Already, Iran is upping its demands and there have even been calls that Iran should be compensated for lost revenues from current sanctions. Negotiating tactics like this could delay the reaching of a final agreement. More importantly, conservative elements of the Iranian regime may harden their position especially with the Iranian presidential elections just around the corner (June 2021). Hardliners would not want to hand Rouhani's camp a 'victory' before the elections. A more probable scenario is that Iran and the US would show gestures of good will at the start of 2021 and reach an interim agreement which would see some Iranian oil coming into the market. After these initial steps, negotiations to reach a full agreement could occur in 2022.

It is too early to speculate whether a compromise could be reached within OPEC+ to accommodate the return of the Iranian barrels. An OPEC+ response would depend on a number of factors, such as the evolution of market fundamentals and how quickly Iran's production would return. But a few observations can be made:

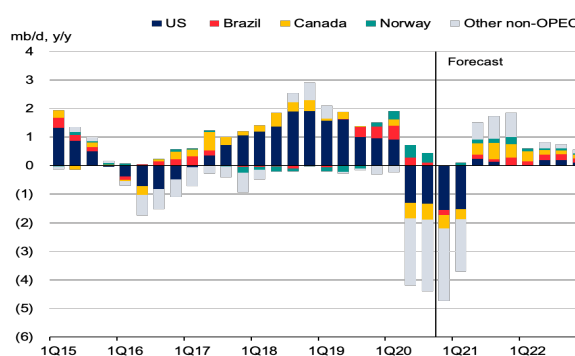
- The y/y swing in demand between 2020 and 2021 could be potentially very large (from -8.6 mb/d in 2020 to almost 6 mb/d in 2021), allowing a smooth return for Iranian barrels (Figure 3). In contrast, the swing in supply, especially from outside OPEC+ is likely to be much more constrained due to lack of investment and limited new projects in the pipeline (Figure 4). The fact that the agreement extends into 2022 gives OPEC+ some flexibility to tweak it to allow the return of some disrupted barrels.
- Second, it is important to note that a Biden administration could impact supply in different ways: by creating uncertainty about prospects for US shale and accelerating the shift towards green technologies, it will make access to finance for US shale increasingly difficult in an already very challenging environment. This means that for US shale companies to grow production, they would have to rely on cash flow. In the current price environment, this would be insufficient to induce a robust pick-up in activity. Also, regulations surrounding new oil and gas infrastructure are likely to become more stringent and permits could face delays. Thus, US shale growth under a Biden administration could be much more constrained, even if prices recover.

Figure 3: Global oil demand



Source: OIES.

Figure 4: Non-OPEC crude supply



Source: OIES.

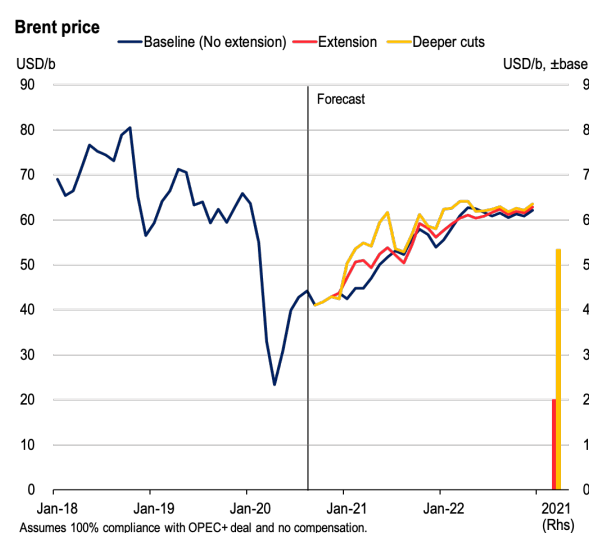
⁵ See also Reuters (2020), 'Iran's oil exports jump in September defying sanctions: TankerTrackers', September 25.

While the market is shifting its attention to OPEC+ dynamics and the return of Libyan and Iranian barrels, the reality remains that this is first and foremost a demand shock and ultimately the evolution of demand will be the key factor shaping oil market outcomes. This demand shock is special in many ways compared to previous shocks: in addition to its size and the speed at which global oil demand contracted, its impact has been highly uneven across geographies (Asia versus the rest of the world) and across fuels (jet fuel and distillate demand versus other parts of the barrel).⁶ This has created a challenge for refineries and their margins have been under severe pressure. The combination of OPEC+ cuts and the return of Libyan barrels have created unevenness in terms of crude quality, with light sweet crudes in abundant supply compared to heavy-medium and sour crudes. The size of the shock and the unevenness of its impacts imply a recovery process which is far from smooth.

OPEC+ Choices

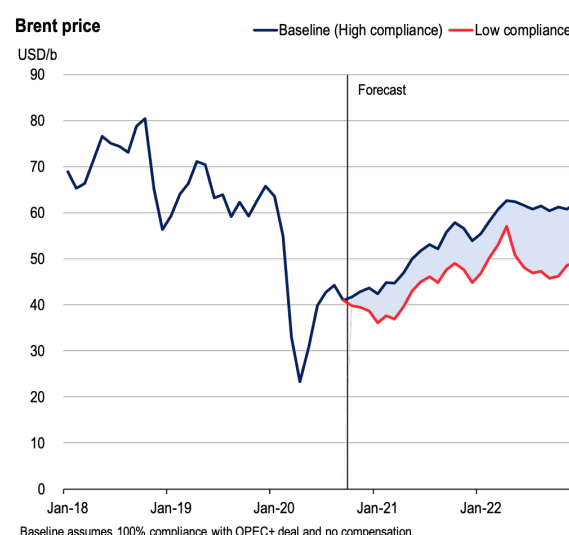
As the OPEC+ meeting approaches, all eyes are on the Group's next move. The main choices facing OPEC+ are taper the cut as planned, extend the current cut (and its duration) by deferring the taper, or deepen the cut. Ultimately, the effectiveness of the OPEC+ response will be shaped by demand conditions. Our results show that by extending the current cut under reference growth of -8.6% in 2020 and 5.9% in 2021 (for scenario purposes we assume a 3-month rollover of the current cuts), OPEC+ will be able to keep oil prices well supported in the \$40/b-\$45/b price range in H1 2021, lifting the Brent price by nearly \$4/b on average compared to our base case of no extension and by \$2/b for 2021 overall (see *Extension* scenario in Figure 5). What is interesting is that in both scenarios (tapering the cut or extending the cut for 3 months), market deficits persist throughout our outlook (barring a rapid deterioration in global oil demand including Asian oil demand).⁷ A shift in expectations of improved fundamentals in the second half of 2021 following the positive news on the vaccine may render the option of withholding barrels today and releasing them when the better times arrive attractive. If demand recovers quicker than expected due to the wide availability of an effective vaccine, the oil price is projected to increase moderately up to \$4/b annually under the extension scenario as any rally will still be capped by existing buffers of inventory.

Figure 5: OPEC+ options



Source: OIES.

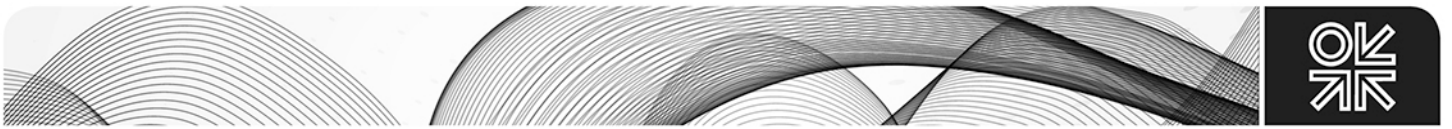
Figure 6: OPEC+ compliance risks



Source: OIES.

⁶ See Fattouh, B. and A. Economou (2020), 'Oil Market Recovery Under Pressure', OIES Presentation, November 9. Available at <https://www.oxfordenergy.org/publications/oil-market-recovery-under-pressure/>

⁷ See Fattouh, B. and A. Economou (2020), 'Oil Market Recovery Under Pressure', OIES Presentation, November 9. Available at <https://www.oxfordenergy.org/publications/oil-market-recovery-under-pressure/>



In the less likely scenario that OPEC+ decides to deepen the cut by 1.9 mb/d, essentially returning to the first phase of the agreement, the price would break the \$50/b mark and average \$52.9/b in Q1 2021, again assuming that demand does not suffer from a new virus-induced shock (see *Deeper cuts scenario* in Figure 5). However, there is a fundamental trade-off with this option, as deeper cuts increase the risk of non-compliance. Our results show that if compliance deteriorates (for scenario purposes we assume that compliance falls to 70% in 2021 and 2022 before producers exit altogether the deal after April 2022), the oil prices in 2021 could lose as much as \$7/b on annual terms, compared to our scenario of full compliance (Figure 6). Thus, whatever decision OPEC+ takes, maintaining high compliance is key. Arguably therefore, maintaining compliance through delivering the taper in January may well be an option to navigate early 2021 in OPEC+ policy terms, with demand setting the course for prices as the recovery picks up pace later in the year. A quarter of weaker prices might be more tolerable and a better trade-off if the effectiveness of the OPEC+ is better preserved for the medium term through ensuring high compliance. Thus, while the evolution of demand will determine the extent of the effectiveness of OPEC+ next move, the view on compliance will widen or constrain OPEC+ choices.