جدوى للإستثمار
Jadwa Investment

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Oil Note: OPEC Announces Production Cuts

Firm follow up needed to avoid price declines

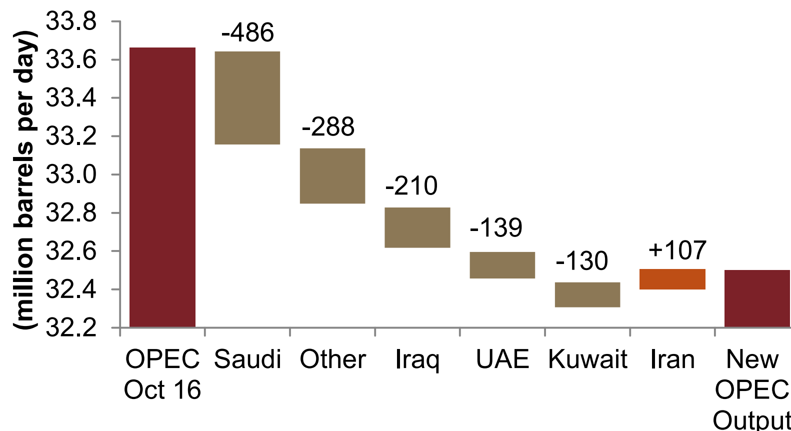
OPEC agreed to cut its own production by 1.2 million barrels per day (mbpd), to 32.5 mbpd, on 30th of November (Figure 1). Oil prices immediately rose by 8 percent following the announcement and, at the time of writing, had reached $54 per barrel (pb). Oil prices could rise even further in the short term, but whether they remain elevated will depend on OPEC implementing its agreement with discipline from January 2017.

The OPEC cuts were agreed upon to, firstly, speed up the act of rebalancing the market, which is now expected to balance more aggressively. Secondly, the cuts were seen as trying to boost prices so to encourage investment in global oil markets, which has dropped dramatically in recent years (Figure 2), and help avoid a potential oil supply crunch a few years down the line.

The key points to emerge from the meeting were:

- A cut by OPEC 1.2 mbpd (to 32.5 mbpd vs. 33.7 mbpd in Oct.). This would commence from January 2017, for 6 months initially.
- The suspension of Indonesia from OPEC as of January 2017. Indonesia produced 722 thousand barrels per day (tbpd) in October 2017. Indonesian production would be distributed amongst current OPEC members.
- Non-OPEC producers proposed to cut by 600 tbpd, of which Russia would cut by 300 tbpd. The details of this would be discussed in a meeting on December 10th.
- Saudi Arabia contributed the most to cuts, at 42 percent of the total cut, equal to 486 tbpd, whilst Iraq, UAE and Kuwait also contributed significantly. Iran was allowed an increase by 100 tbpd, whilst Libya and Nigeria were given exemptions (Figure 1).

Figure 1: OPEC agreed to cut production by 1.2 mbpd to 32.5 mbpd (vs. 33.7 mbpd in Oct.) starting from January 2017*



*Other includes: Angola, Ecuador, Gabon, Qatar, Venezuela

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Potential impact of cuts on oil prices

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...and assume that there are disciplined OPEC cuts at agreed levels...

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...with Brent oil prices rising to a minimum of $60 pb for 2017.

If we disregard the hurdles to the current deal, and assume that there are disciplined cuts at agreed levels, then we would expect to see oil market balancing being more aggressive than previously . If OPEC decides to continue with the agreement beyond the initial six month period, when in meets in May 2017, this would result in tighter oil markets in the second half of 2017 as well (Figure 3). Oil markets could fall into deficit by a sizable 1.4 mbpd in Q3 2017, compared with a deficit of just 200 tbpd with no cuts. In fact, oil markets in 2017, on average, would be in deficit by 730 tbpd compared to a surplus of 1 mbpd with no OPEC action. Such a turnaround in oil market balances would have a positive effect on Brent oil prices. We estimate that the minimum impact would be a rise in Brent oil prices to $60 pb for 2017, compared to our current forecast of $55 pb. This could rise even further if the proposed non-OPEC cuts of 600 tbpd were agreed and implemented.

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...with a decline in these stocks being the second part of rebalancing equation, in addition to daily oil balances.

A rise in Brent oil prices could also help push down commercial crude oil inventories. In the last two days, Brent oil prices for prompt delivery (in February 2017) versus delivery in a year's time, have narrowed (Figure 4). Although Brent oil prices are still in contango (spot prices being lower than the forward price), further rapid rises in Brent could see oil markets go into backwardation (spot prices higher than the forward price). In such a situation, it would make sense to sell commercial crude stocks now rather than at potentially lower prices in the future. Commercial crude stocks have been substantially above their long term average since mid-2014, so a decline in these stocks would be the second part of rebalancing equation, in addition to daily oil balances.

Plentiful risks ahead

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A multitude of risks still remain relating to the OPEC deal, most of all being non-compliance by OPEC members themselves. As we pointed out in our recent publication [Quarterly oil Market Update (Q3 2016): Are Oil Markets better off with OPEC cuts?], OPEC has a poor record in complying with its own targets. Looking back at OPEC production data since 2001, there has been limited compliance with the organizations targets, with total production consistently exceeding production ceilings.

Figure 2: Global oil industry has seen large falls in upstream capital expenditure since 2014

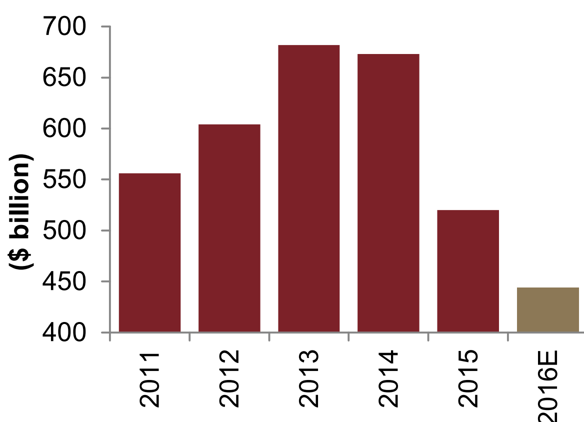
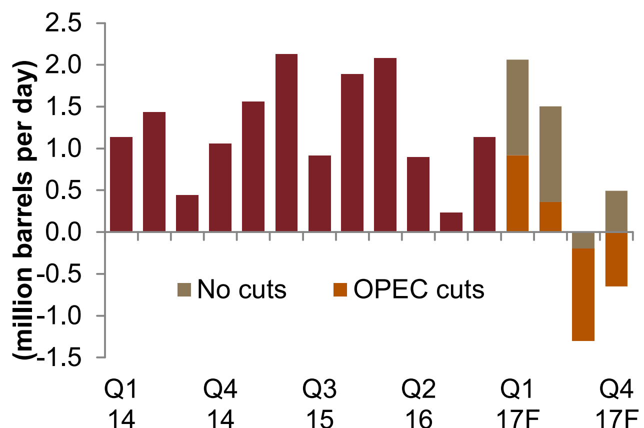


Figure 3: Oil market to balance more aggressively and quickly with OPEC cuts



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In addition, there is the risk of shale oil rebounding as oil prices edge upwards. A price of around $45 pb is estimated to cover well-head (or half cycle) operating costs at three of the major shale basins, which, in turn, gives many shale oil producers the opportunity to limit year-on-year production declines and add to overall US oil production. Furthermore, if what has been stated in the recent past is implemented by the new US President, then rises in US oil supply could occur. Specifically, Trump's policies have been geared towards freeing up oil exploration, production and transportation from bureaucracy. With the export ban on US crude oil lifted at the beginning of 2016, this could see a ramp up in US exports of crude oil and refined products, but it is still too early to call.

Potential impact on Saudi economy

Assuming Brent oil prices of $60 pb and Saudi crude oil production at 10 mbpd in 2017, we calculate…

...Saudi export revenues rising by $10 billion vs. our current forecast…

...current account deficit improving to 2.2 percent of GDP, vs 3.1 percent of GDP...

...and the budget deficit shrinking to 4.8 percent of GDP vs. 5.8 percent of GDP currently.

Putting all the above risks to one side, and assuming a full OPEC implementation of cuts, we would, as mentioned before, expect Brent oil prices to average a minimum of $60 pb in 2017, compared to our current forecast of $55 pb. At $60 pb, but lower crude oil production for the Kingdom at 10 mbpd, as per OPEC's agreement, we would expect a marginal improvement in our forecasted external balance for the Kingdom. For 2017, we would expect oil export revenues to rise to $170 billion, up from $160 billion in our current scenario for the year. This improvement would help reduce the current account deficit to $16 billion (2.2 percent of GDP), compared to $21 billion (3.1 percent of GDP) in our current scenario. Higher oil revenues will also mean that the Kingdom's fiscal balance would improve. The 2017 budget deficit would shrink by SR24 billion compared to our current scenario (from 5.8 percent to 4.8 percent of GDP) (Figure 5).

At this moment in time we have not revised our current forecasts.

Overall, whilst the OPEC cuts represent an up-side risk to oil prices, due to the hurdles mentioned above, namely risks to implementation and a rebound in US shale, we are not revising our current forecasts but will be monitoring developments closely.

Figure 4: Difference between price of prompt oil delivery vs. delivery in Dec. 2017 has narrowed

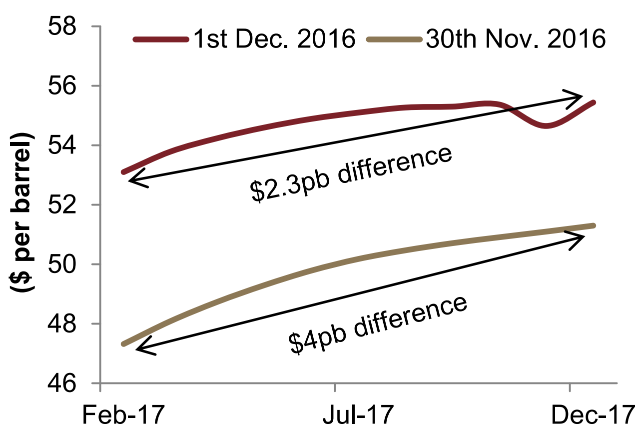
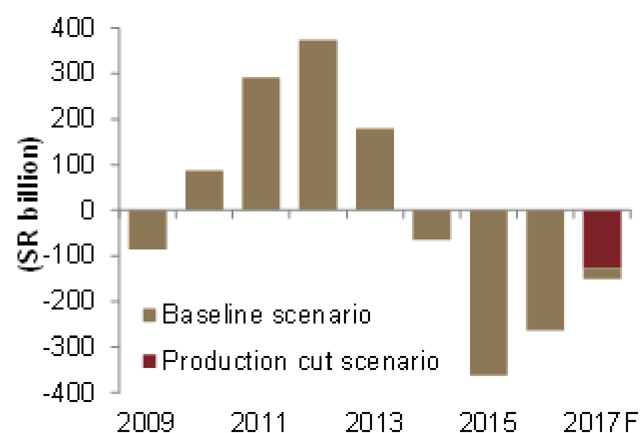


Figure 5: Saudi Fiscal Balance



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