Crude Oil

Nothing fundamentally has changed

Thursday, September 29, 2016

Highlights

- The OPEC cartel has agreed to an oil production cut to a range of 32.5 to 33 million barrels per day (mbpd). It has been eight years since any agreement of a production cut materialized. This cut will only be enforced in its November OPEC meeting, in-line with our call for the informal meeting to ‘set the stage’ for more comprehensive action in its official November meeting.
- The key question remains to be: Is this production cut be enough to arrest the supply glut? The quick answer is remains to be a resounding ‘no’. The cut of as much as 0.9 mbpd from OPEC’s current production of 33.4 mbpd, is grossly small compared to its previous production quota of 30.0 mbpd made many years ago.
- Still, this announcement gives market-watchers the assurance that the OPEC *will* do something in its upcoming November meeting. The OPEC members should know that a 0.9 mbpd cut is insufficient to bring the demand-supply equation to a balance. In a nut-shell, more can be expected in its November meeting then.

The supply glut continues

The need to re-capture lost market share has finally caved in to the necessity of higher oil prices. In a clear sign of desperation, the members of the Organisation of the Petroleum Exporting Countries (OPEC) had to meet ‘informally’ in the side-lines of the International Energy Forum in Algiers, this time in a concerted unity to rubber-stamp a production cut. It has been eight years since a cut was mentioned. It only took six months for Khalid Al-Falih to get nods from his colleagues in agreement for an oil deal.

Amid the hype over the production cut, it is important to note that the proposed cut is lacking many aspects. First off, the cut will only be enforced (assuming it will be) at OPEC’s official meeting in November later this year. This means that OPEC production will still adopt the “pump-at-will” policy from now to November. It also further suggests that the nothing fundamentally has changed in the oil supply-demand equation. In a nutshell, the oversupply glut continues.

Secondly, the production cut will not be enforced in Iran, Nigeria and Libya. Iran has repeatedly iterated its goal to lift overall production to 4.0 mbpd (currently at 3.6mbpd), while domestic issues in Nigeria and Libya has consistently curbed their production levels. With the exclusion of these three nations, we view that the production cut framework may not be as iron-clad as before – the collective production of Iran, Nigeria and Libya accounts for a sizable 15.9% of total OPEC production as of August 2016, down from a five-year average (2005 – 2010) of 24.9% of total OPEC production. This suggests that the exclusion of these three nations will potentially leave one quarter of total OPEC production out of the production cut out of the deal, and upside production surprise by these nations into the coming years is a real possibility, this time with no framework to govern them.

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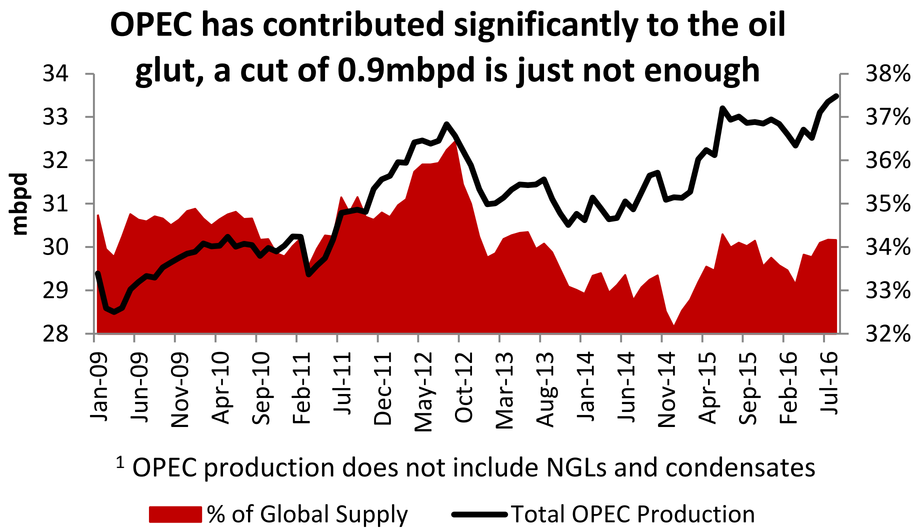


Source: Bloomberg, OCBC Bank

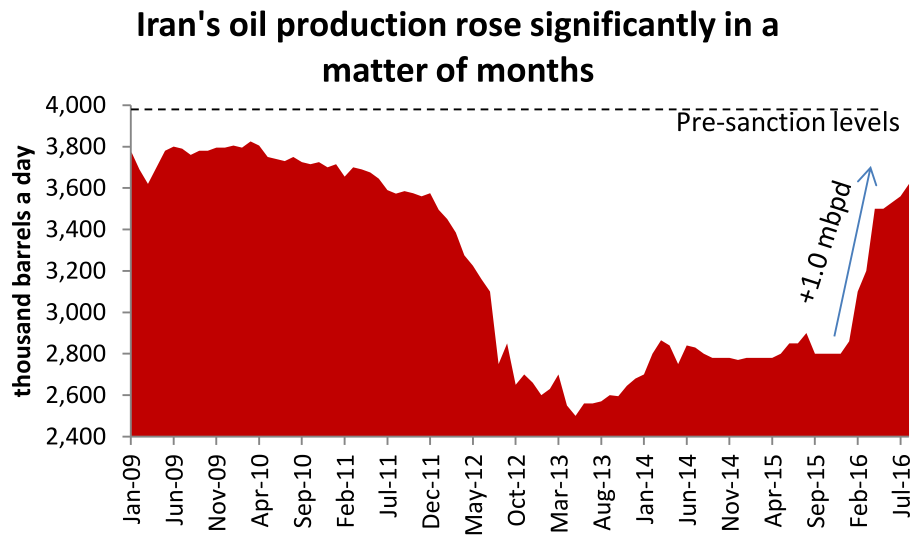
Last but not least, the production cut is too small, and too sketchy for market-watchers to find continued assurance. The said agreement to cut production had stealthily left a key information piece absent – individual production quotas for each country. For one, Saudi Arabia is expected to give up 350 thousand bpd, according to an unnamed senior OPEC official. As to how the rest of the cuts of 550 thousand bpd be allocated to the rest of the members is still an unknown. For the skeptics perhaps, OPEC has repeatedly been unable to adhere to its production quota in the past given the lack of individual production quota, and this time, it seems that it is no different as well. Elsewhere, a cut of a total of 0.9 mbpd is too small (or a mere 3.0% from the current 33.4 mbpd), should we compare this with the hefty production increase from its previous quota of 30 mbpd made back many years ago.

A more comprehensive deal to be expected?

Despite the lack of details of the production cut, the move to signal OPEC's willingness to cut oil production confirms (1) the change in direction by the OPEC cartel to want higher prices and (2) a more comprehensive oil deal in its November meeting.

Looking into OPEC's November meeting, we offer possible scenarios as to how it may pan out. Top of our list is for OPEC to announce the enforcement of individual production quota for each and every producing member. The existence of individual production quotas will then allocate the burden each member has to take in limiting oil production, thus giving the OPEC cartel the muscle to enforce its newly announced 32.5 mbpd quota. Of course, the challenge will then be to convince each member to shoulder and adhere to the said individual quota.

We also envision Iran playing a greater role in limiting oil production. Iran has repeatedly voiced its aim to print pre-sanction levels of 4.0 mbpd. Iran has shown its ability to accelerate production quickly in a matter of months after sanctions were lifted, and should the pace sustain, Iran would just be in time to touch its pre-sanction level in November. By then, Iran may be more willing to negotiate to freeze production the 4.0 mbpd handle, adding more credibility to OPEC's purported overall 32.5 mbpd production quota.

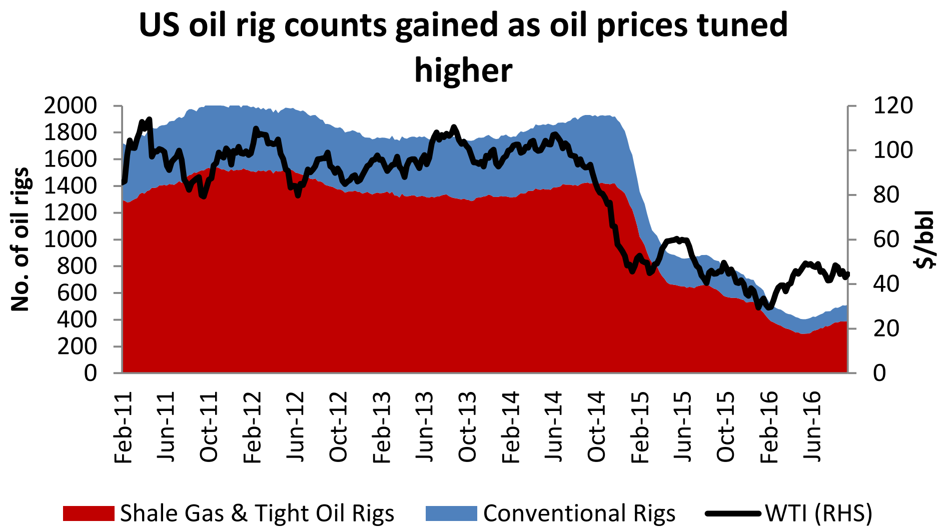


Source: Bloomberg, OCBC Bank

The collaboration of other non-OPEC members, such as Russia, may also be sought after nearing its November meeting. Russia has been seen to be in agreement for an oil deal during this time of low oil prices. It has previously agreed to freeze its oil production earlier this year, in tandem with OPEC's call for non-OPEC nations to play its part in narrowing the supply glut. As such, the careful calibration of OPEC's oil supply, as well as the need to maintain market share, will then prompt OPEC to bring non-OPEC nations to the discussion table.

Crude oil outlook

The fact remains that nothing fundamentally has changed. WTI and Brent have surged considerably to near its $50/bbl handle at the onset of OPEC's surprise announcement. However, the supply glut will continue, as no cuts are implemented, yet. Even with the recovering oil prices at this juncture, we do not think the uptrend is sustainable – crude oil supplies especially from the US shale industry may come back to the grid, a phenomenon already seen when oil prices rallied in the middle of this year.



Source: Baker Hughes, Bloomberg, OCBC Bank

The potential rise of US oil production as oil prices tune higher is a persuasive driver to send oil prices lower again. This suggests that the rally in oil prices may be short-lived in the months to come. Still, we find comfort for an oil production cut to materialize in OPEC's November meeting, while global oil demand to strengthen further in tandem with global growth. All these points to the sustained re-balancing scenario – the supply-demand environment is likely to fully balance by the second half of 2017. But for the rest of the year, some knee-jerk reaction to result in lower oil prices may be seen in the months ahead, before a recovery to the $50/bbl handle may be seen from OPEC's eventual cut in November amid a gradual increase in global demand then.