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Saudi-Russia OPEC+ policy divergence to be short-lived

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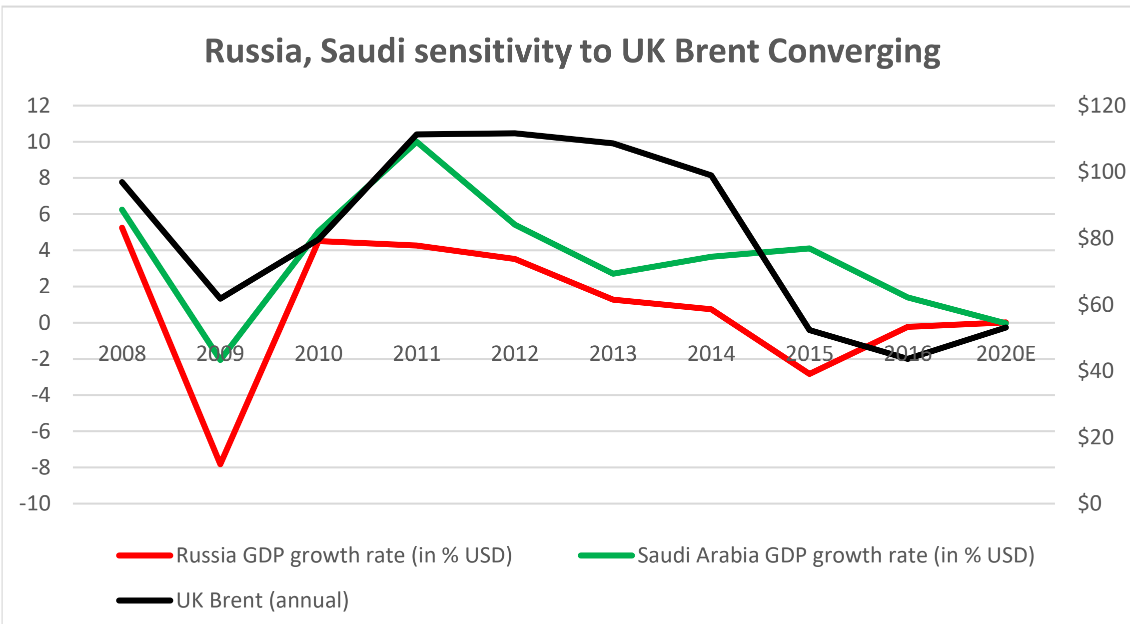
The depth and rapidity of the selloff in crude oil since late October has made some sort of headline production cut very likely at the 6 December OPEC/Russia ministerial meeting in Vienna. However, the reasons for the selloff on the supply side – mainly upward revisions to US production data thus far in 2018 and forecasts for 2019 – strongly suggest a lower equilibrium price and the inability of cartel behavior to support a price for Brent in excess of the mid-$60s for an extended period of time. The volume loss from sanctions on Iran heading into 2019 will be larger than many market participants expect, which along with an OPEC+ cut could push Brent back into the mid-$60s in the near-term, but what started out as a selloff driven by concerns about slowing economic growth in 2019 has gained momentum due to the shift in focus to anticipated 2019 non-OPEC supply gains. The clearly divergent preferences between Saudi Arabia and Russia will lead to a vague compromise without a clear commitment by Russia to go roll back its production to the previous target of 10.7 million bpd and a de facto acceptance by the Saudis that they will bear a disproportionate share of the burden this time.



Source: US EIA/ CBOE/ UN Stats/ DaMina Advisors

Sanctions on Iran failed to stave off the day of reckoning

The relevant question at this point isn't whether cartel behavior can help to stabilize the market – it can – but rather the price point which is attainable. At the beginning of 2018, many oil bulls argued that US shale oil production had hit the limit to its' growth rate – due to shortages of labor, a declining learning curve, service cost reflation, pipeline capacity, producer discipline, etc. A ceiling at around 1 million bpd per year of annual growth was widely cited. Now, recent revisions to the US data and forecasts have discredited those notions. EIA's final numbers showed almost 400,000 bpd in US supply growth just between June and August. In hindsight, the flattening out of US inventories before the end of the summer driving season should have been taken more seriously as a sign that preliminary production estimates might be too low. Based on EIA forecasts and data, US crude production is now the largest in the world at 11.6 million bpd, and forecast to pass 12 million bpd by Q2 2019.

For OPEC (and Russia and Oman, the only two non-OPEC countries which actually cut production in 2017-18 beyond their decline rates), the evidence is now clear – when US light crude sells for prices in the $60s or above, production growth accelerates sharply, with a time lag of only 4-5 months. The worse-than-expected collapse in Venezuelan production over the last two years as well as the initial drop in Iranian export volumes due to looming US sanctions masked the impact of this growth for most of the year, in a way somewhat similar to the way sanctions and conflict in Libya did in 2012-1H 2014, but it has now accelerated to a tipping point, and much of the 2019 production has already been hedged forward. Thus, OPEC faces another short-term versus long-term tradeoff.

MBS is focused on short-term revenue…

For Saudi Arabia, the focus is very clearly on the short-term. MBS is under pressure over the Khashoggi affair, the delayed Saudi Aramco IPO, and other issues, and having to reduce the surge in spending which has supported GDP growth would be painful. The agreement with President Trump to offset volume losses from sanctions on Iran is still important, but the US would not strongly object to a modest production cut which simply avoided big inventory gains and pushed WTI back to the upper $50s or low $60s. US oil producers, of course, are very happy to take more market share from OPEC and hedge their production forward pegged to a price curve propped up in the near-term by OPEC. That would limit any genuine White House annoyance with the Saudis, even if President Trump, as a populist, needed to complain about it on Twitter. Press reporting on 15 November indicating that MBS is angry with Trump for granting the waivers for countries to continue to purchase some Iranian crude oil may be accurate, but if so it just underscores that he is still in denial about the unsustainable nature of the $80+ price range he would prefer.

… but Russia is more realistic about sustainable prices

For Russia, though, it looks a lot different. The Russian oil industry has consistently cited Brent prices around $60 per barrel as where they think the medium-term price equilibrium is located. President Putin overruled Igor Sechin in his decision to cooperate with OPEC and extend the cuts, but the differences between Saudi and Russian views were already on display at the December 2017 OPEC meeting, when Russia signed up for a full year of cuts, but insisted on language about a review at mid-year. If the US decision to re-impose sanctions on Iran hadn't shifted Saudi oil policy back into the realm of "high politics" with the US, the June meeting could have been contentious. In addition, Russian oil production has rebounded much more sharply than most observers had expected – reaching 11.4 million bpd currently. If Russia does agree to a cut in December, it could insist on starting from this as a baseline rather than the previous agreement. Russian industry figures like Lukoil's Vagit Alekperov have again started publicly stating their opposition to a cut, but President Putin and Oil Minister Alexander Novak have kept to the "continued cooperation" pledge while saying it is unclear if anything actually needs to be done.

Iraq also has seen its production grow more than expected since June. It never complied fully with its share of the December 2016 agreement, averaging less than half of the pledged volume reduction, but it now could be in a position to argue that it should start from a higher baseline given investment in new capacity. Iraq also recently agreed with the Kurdish Regional Government to restore some Kirkuk oil to the Kurdish controlled pipeline to the Turkish port of Ceyhan, which is made more important by the recent cessation of truck-borne exports of

Kirkuk crude to Iran. That internal political complication would make it harder to comply with a substantial production cut.

G-20 summit will be an important milestone for both OPEC/Russia and demand expectations

The upcoming G-20 summit meeting in Buenos Aires will be a very important milestone on the way to the OPEC/Russia ministerial, and could see tentative deals reached. It is still unclear whether MBS will attend on behalf of Saudi Arabia or send a representative, but there will definitely be substantive discussions on the sidelines between Saudi and Russian officials about what form of “cut” language they could agree on. Russia will not force its producers to go all the way back to 10.7 million bpd, but could implement a much smaller cut. Saudi Arabia, however, may have to accept vague language about restoring previous reductions, which they could interpret as taking them back to around 10 million bpd, and Russia could interpret as from current levels. The United Arab Emirates would probably cooperate with the Saudis, as could some others like Kuwait, but most of the rest of OPEC has either lost capacity since December 2016 or was exempt. Libya has recently hit a post-revolution high of 1.28 million bpd, but it has been very clear that it will not give up its exemption. Iran, ironically, could endorse a Saudi-backed cut, since it could modestly enhance the value of Iranian exports while the Saudis give up a disproportionate market share. Iraq, as with the previous cuts, would probably only partially comply.

The new reality being digested by all of the producer governments is that while production restraint under the December 2016 OPEC/Russia deal succeeded in draining excess inventories, it also unleashed a tsunami of non-OPEC (mostly US) production growth. Thus, even with the Saudi de facto ruler still in denial about the future, more producers are going to opt in favor of managing the market’s decline to equilibrium (and preventing a deeper price collapse) rather than trying to return to prices which are clearly unsustainable.

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