OPEC's Elusive Course Out of the Doldrums

*By Antoine Halff**

October 5, 2016

OPEC's agreement in Algiers on September 28 marks the cartel's first attempt in eight years to manage the oil market through supply cuts. Career OPEC pundits gave it mixed reviews. The market, however, gave it positive early reviews. In appearance the deal could indeed be seen as a triumph of self-reassertion and regained market power, but on closer inspection it shows how formidable the challenges facing the organization remain – and how increasingly ill-equipped OPEC appears in its efforts to address them.

Oil prices jumped on the news, even though the deal, the details of which were left to a later time, still amounts to little more than a declaration of intent and has yet to provide any real relief for glutted markets. Both US benchmark WTI and international benchmark Brent posted gains of more than $3 per barrel at the end of the week, with the latter settling over $50 per barrel. Those gains are of a lesser magnitude than the declines that greeted OPEC's surprise decision not to cut supply in November 2014, but do reflect some underlying market nervousness. Some analysts have hailed OPEC's move as "clearly bullish," others see it as just "kicking the can down the road, " and still others give OPEC credit for changing market sentiment but doubt that it can deliver.

However, most observers seem to concur that OPEC's return to supply cuts marks a step backwards -- a rejection of the policy seen over the past two years and a more or less explicit admission of failure – and differ only in their assessment of how determined and effective the group is likely to be in executing its plan. That is too simplistic a view. While some OPEC countries face acute and ever-mounting pressures from low prices, OPEC's laissez-faire approach made perfect sense for Saudi Arabia and its GCC neighbors two years ago and has in fact met with a measure of success, until now. Things have changed, however, and new circumstances call for new policies. Shifts of deep significance have taken place on at least three fronts: in the oil market; within OPEC itself and in the balance of power between its members; and inside the Kingdom of Saudi Arabia. Given the magnitude of these changes, the real question is not whether OPEC can execute its proposed cuts but whether opening up its old toolkit can really solve its problems.

Shifting Oil Market Dynamics

Let's start with the oil market. OPEC's laissez-faire policy was driven by the realization that US shale oil supply had changed the playing field for oil producers. Thanks to the short lead times and payback times and low initial capital requirements of shale oil companies, any OPEC production cut ran the risk of subsidizing shale producers and abandoning market share to them without inducing a lasting price recovery. Nimble shale producers could quickly capitalize on a price rebound to double down on their investment and raise production, thus driving prices down again and expanding their market share at the expense of OPEC. Not only did Saudi Arabia and its neighbors refrain from cutting production at the November 2014 OPEC meeting, they dramatically raised their output in an apparent bid to drive down prices further, force high-cost producers out of the market and regain market share. Both Saudi Arabia and Iraq lifted supply by roughly 1 million barrels per day from mid-2014 levels. Kuwait, the UAE and Qatar followed suit.

The tactic has paid off – up to a point. Riyadh and its OPEC partners have succeeded in putting a floor under prices and driving shale supply substantially down. Two years into this process, however, the oil market recovery appears to have stalled. The oil price has been stuck for months in a $40-$50/bbl band. Saudi Arabia's all-out drive to ramp up production is running out of steam, as is that of its neighbors. At the same time, non-OPEC supply is showing signs of life. In the shale patch, steady production gains in the Permian Basin are eclipsing declines in the Bakken and Eagle Ford plays. The US rig count appears to have bottomed out. Outside of the US, more conventional producers are learning, in the words of the International Energy Agency, to do more with less. Despite steep budget cuts, Norway's production hit levels not seen since 2011 in August, reversing years of decline. Russia's output likely topped 11.1 million barrel per day last month, an all-time record, even as it tried to cajole OPEC into a supply cut.

For Riyadh and its neighbors, both past achievements and renewed threats seem to call for a new approach. What worked well in the last two years may no longer prove as effective. On the plus side, after steep drops in the rig count and more than two years of spending cuts, some lasting harm has likely been inflicted on shale capacity outside of the Permian. Despite improvements in productivity and drilling efficiency, shale's so-called swing capacity has likely been degraded from where it was in November 2014, and Riyadh has probably less to fear now from a shale price response than it did then. Hence there is less downside risk from supply cuts now.

On the other hand, the Saudi-GCC policy of overproduction is getting more expensive and increasingly unsustainable. While the ramp-up in supply has defied expectations, current prices no longer seem low enough to stop non-OPEC production from catching up with Saudi supply gains. As non-OPEC producers seemingly adjust to the current low price reality, preventing them from raising their output would likely require OPEC to orchestrate another round of price drops. At the same time, the higher Saudi and other GCC production levels get, the more expensive further gains become. So while it made sense for the Saudis to boost production these last two years, the cost/benefit calculation of adding more production has changed. Forcing prices lower through another and far costlier round of Saudi production increases might not be worth the expense.

Changes within OPEC

The situation within OPEC has also changed dramatically over the last two years. At the November 2014 meeting, Saudi Arabia called the shots. Its embrace of laissez-faire oil policy set group policy over the objections of other members, including Iran. The latter, in contrast, was diplomatically marginalized, handcuffed by crippling international sanctions and unable to ramp up output. Today a resurgent Tehran is counter-balancing Riyadh, which seems increasingly preoccupied by two live wars in Yemen and Syria and an ambitious but challenging National Transformation Program.

Early signs of this new reality could be seen at OPEC's April 2016 meeting in Doha. Then Oil Minister Ali Al-Naimi of Saudi Arabia walked in carrying a draft agreement to freeze production whether Tehran joined in or not – or even attended the meeting. Saudi officials had specifically let it be known that they would not let Tehran set the course of their oil policy. Deputy Crown Prince Mohammed bin Salman saw it otherwise, however, and told western reporters that any deal was conditional on Iran's participation. Riyadh would only agree to supply limits if Tehran did its share of the cuts. Tehran stayed away from Doha, and the pre-negotiated agreement was scrapped.

Fast forward to Algiers. Khalid Al-Faleh led the Saudi delegation with the expanded portfolio of Energy Minister, after Naimi had been allowed to retire at age 80,. Not only was his Iranian counterpart Bijan Zanganeh very much in attendance at both the International Energy Forum ministerial conference – which brought the ministers to Algiers in the first place – and the OPEC meeting, he went out of his way to cast himself in a leadership position. It was Zanganeh who broke the news of the group's return to market management, even before OPEC announced it officially. OPEC's communiqué, when it was finally issued, seemed tailored to Tehran's specifications. Its introductory paragraphs on market conditions read like a thinly veiled indictment of Saudi policy:

> "In the last two years, the global oil market has witnessed many challenges, originating mainly from the supply side. As a result, prices have more than halved, while volatility has increased. Oil-exporting countries' and oil companies' revenues have dramatically declined, putting strains on their fiscal position and hindering their economic growth. The oil industry faced deep cuts in investment and massive layoffs, leading to a potential risk that oil supply may not meet demand in the future, with a detrimental effect on security of supply.
>
> The Conference took into account current market conditions and immediate prospects and concluded that it is not advisable to ignore the potential risk that the present stock overhang may continue to weigh negatively well into the future, with a worsening impact on producers, consumers and the industry."

By pointedly framing the market assessment against the larger backdrop of the "last two years" and pointing out the perils of "ignoring" market risks, the communiqué paints OPEC's Saudi-led policy since November 2014 as one of irresponsible neglect. Such a choice of words, and Riyadh's acquiescence to them, seems every bit as remarkable as the policy shift for which it provides a rationale.

Signs of Iran's regained influence within OPEC do not stop at what is explicitly covered in the communiqué but also include what is left out of it. While the agreement leaves the details of the production cut (or freeze) to OPEC's next meeting on November 30 in Vienna, the ministers allowed in interviews that Iran, along with Nigeria and Libya, would be excused from any cut, in consideration of their special circumstances. It is in fact far from clear that Iran has the capacity to push production above recent highs, but its exclusion from the deal is a signal achievement. Unlike in April, Riyadh agreed to a deal without Iran's participation.

Generally speaking, compared to Saudi Arabia, Iran is weathering low oil prices fairly well. Since November 2014, Iranian production has jumped by nearly one third, from 2.76 million bpd to 3.64 million bpd. Saudi production has over the same period registered slightly faster growth in absolute terms but a far smaller percentage gain, up just 11% from 9.61 million bpd to 10.65 million bpd, according to IEA estimates, even as Brent prices dropped from roughly $80 to around $45/barrel. Since sanctions were lifted, Iran's production gains have thus largely offset price declines, whereas for Saudi Arabia the revenue loss has been far more severe. While the hardship inflicted by international sanctions on Iran likely helped bring it to the nuclear talks, they have also prodded it into the kind of economic reforms that Saudi Arabia is only now beginning to undertake. Iran's economy today is far less "addicted to oil" than Saudi Arabia's.

Saudi Arabia in Transition

For the Kingdom, the challenges of implementing sweeping reforms are also bringing far-reaching changes, and perhaps a measure of bureaucratic turmoil, on the domestic scene. The government is hard at work fleshing out its "Vision 2030" and turning its National Transformation Plan into reality. Deputy Crown Prince Mohammed bin Salman appears to have moved past the agenda-setting stage, into the difficult execution phase. His media appearances have been less frequent and he was conspicuously quiet on oil policy ahead of Algiers. Others have not been so discreet. As trade newsletter *Petroleum Intelligence Weekly* noted in the run-up to the meeting, "there are too many Saudi voices sending too many confusing signals, with the most important voice, Deputy Crown Prince Mohammed bin Salman, so far opting for silence." Energy Minister Al-Falih seemed to express in an August press release the Kingdom's willingness to discuss "any possible action" to stabilize markets. However, he later "appeared to rule out joint action, saying a freeze was not necessary and that the market would balance on its own" according to Petroleum Intelligence Weekly[1] – even as Foreign Minister Adel Jubeir repeatedly endorsed the idea of a production freeze but stuck to Prince Mohammed's demand that Iran participate. In contrast to the disciplined messaging that prevailed under Naimi, different officials sent out conflicting signals – perhaps a reflection, in the view of some observers, of crisscrossing reporting lines in a Saudi government in which various branches are striving to implement their young leader's vision independently from one another.

Much has been made since OPEC's return to market management of Saudi Arabia's growing fiscal problems, and of its interest in securing a higher oil price ahead of a planned debt issuance and partial privatization of state oil company Saudi Aramco. Even as the group's oil ministers were converging in Algiers, Riyadh announced sweeping belt-tightening measures for the public sector, including 20% cuts in ministers' salaries, reduced housing and car allowances, and scaled back annual leave. Saudi Aramco would also naturally be better valued at a higher oil price, thus making an IPO of a 5% stake in the company, planned for 2018, more profitable. But it seems illogical to see, as do many, the Kingdom's fiscal hemorrhage and revenue needs as the prime reason for OPEC's change of heart on production policy. Riyadh's concerns about lost revenue, while they may be mounting as the Kingdom keeps drawing on reserves, are nothing new. It is precisely out of concern for lost income that Riyadh two years ago embraced laissez-faire policies as the safest way to restore its revenue stream. That was a sensible bet at the time. The same concerns today dictate a new approach, as well as a ramp-up in spending cuts

But the public-sector cost-cutting announcement could not have been timed more poorly if Riyadh had been intent on bolstering its negotiating posture in the OPEC talks. As such the timing is intriguing, and seems to indicate either lack of coordination among government branches (which would be understandable given the scope of the reform underway), reassurance to other producers that the Kingdom is sharing their fiscal pain or a deliberate attempt to ostensibly join in, and provide context for, the rejection of its own past policies.

Pump and Ceremony

[1] Petroleum Intelligence Weekly, "Chorus Effect Muddles Saudi Messaging," Sept 12, 2016.

At the end of the day, the Algiers deal seems more like a supply freeze than an actual production cut. Beyond the dramatic declarative effect of OPEC's ostensible return to market management, the cut itself is arguably insignificant. The group's oil ministers have agreed to keep OPEC-14 supply within a range of 32.5 million bpd to 33 million bpd. OPEC itself estimated its output in August at 33.24 million bpd, just 240,000 bpd above the band's upper limit. The IEA pegged it slightly higher, at 33.47 million bpd, Platts at just 33.13 million bpd. Saudi production normally edges down seasonally in the fall from summer highs, when crude burning for electricity generation and air conditioning peaks. Some West African capacity was due to shut down for maintenance this fall. So the agreed supply band seems more like a gloss on the production constraints of an over-extended group of oil exporters than a hard commitment to substantially reduce output.

Ironically, despite its insignificance, implementing the cut still offers major hurdles. As has been widely noted, the ministers agreed to set up a high-level committee of member-country representatives, supported by the OPEC Secretariat, to "study and recommend the implementation of the production level of the Member Countries." In addition, the Committee "shall develop a framework of high-level consultations between OPEC and non-OPEC oil-producing countries, including identifying risks and taking pro-active measures that would ensure a balanced oil market on a sustainable basis, to be considered at the November OPEC Conference." Acrimonious comments have already started, with Iraq's oil minister preemptively fighting under-estimations of his country's oil production baseline. Despite being present in Algiers for the IEF Ministerial meeting, Russia and other non-OPEC producers were left out of the agreement. Future attempts to bring them in seem unpromising.

The Algiers meeting started as an informal consultation and was eventually elevated to a formal event, the "170th (Extraordinary) Meeting of the OPEC Conference." The communiqué penned by the Ministers is long on descriptions of the threats facing the oil market and producer countries but short on solutions. It does a great job of stressing the gravity not only of the present situation but also of the future imbalances that may result from current underinvestment. The rejection of laissez faire and the return to market management were calculated to capture the market's imagination. Beyond the pump and ceremony, however, the meeting did not really suggest any credible pathway to sustainably higher prices. It failed to produce any real assessment of past policies, preferring instead to dismiss them as a form of inaction or neglect. It shrank from addressing in any detailed way the specific challenges facing OPEC and the rest of the industry as a result of shale oil and climate policy. The cuts it proposed are minimal, even symbolic, yet implementing even so marginal a set of production constraints has been left to later and seems a daunting challenge.

The market may in the end rebalance on its own, perhaps even with a vengeance, following years of under-investment and accelerating decline rates, but OPEC's invocation of market management will likely have little to do with it. Simply invoking the market management techniques of yesteryear will not help overcome the twin challenge of shale oil and slower demand growth. OPEC members are either on the brink, like Venezuela and Nigeria, or, like Saudi Arabia and its neighbors, deep in a process of national transformation and self-reinvention. Other international energy organizations like the International Energy Agency have been busy for years recasting their mission and redefining their purpose in a market increasingly focused on renewable energy and climate change. Consumer countries are revisiting the role of their strategic reserves. OPEC remains an important institution and demonstrated in Algiers a certain sense of resolve and unity, but has yet to follow suit and engage in the kind of far-reaching reexamination of its toolkit and mission that changing market and historical circumstances call for.

---

*Antoine Halff is Senior Fellow and Director of the Global Oil Markets Research Program at the Center on Global Energy Policy, Columbia University. His 20-year career in energy spans the worlds of government, international organizations, consulting, Wall Street, higher education and the media.