OPEC's Catch 22?

By Antoine Halff

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Six months after OPEC "came back" from two years of not interfering with oil markets the producer group will meet again in Vienna this week to chart its production course. Historically, the group's supply management efforts have been criticized for both their successes and their failures: OPEC has been alternatively chided for flooding the oil market and for starving it, for its lack of discipline in withholding supply and for its extortionist policies. This time around, the group faces an entirely new predicament. Producers are being given high marks for compliance with the cuts to which they agreed in November 2016, but OECD oil inventories – whose record-high levels had been weighing down on prices, and which the group had pledged to drain– are barely budging. OPEC has never been more disciplined, nor less powerful.

The reason for this paradox seems obvious: The U.S. shale oil industry is robbing OPEC of its price-making (or price-influencing) power. With its short lead times, low upfront capital costs and relentless ingenuity, shale oil has gained such a competitive edge that OPEC's policy tools are backfiring: the more disciplined the group is at cutting production, the more easily shale producers can find money to drill, frack and boost supply, capturing the benefit of OPEC's actions and slowing the market's rebalancing. The difficulty OPEC has had in providing support to oil prices despite reportedly high compliance with its 2016 production targets, seems to vindicate the decision the group made in November 2014 to let prices fall in order to root out higher-cost supply. But that policy too had proved ultimately ineffective, as OPEC supply gains more than offset non-OPEC declines. In the run-up to this week's meeting, the wounded monopoly thus finds itself in a bind: it can either extend – or deepen – its production cuts, raise prices and give the shale oil industry more support, or unshackle its exports and flood the market, and lower oil prices. Damned if does extend the cuts, and damned if it doesn't.

There is an alternative view, though. OPEC has been grading itself on its compliance record, and giving itself flying marks. The problem with the "shale vs. sheiks" theory is that it takes that self-appraisal at face value, and assumes that the group has been cutting production as steeply as it claims to have done. Hard evidence from new data sources suggests otherwise. Although traditional market watchers point to exceptionally high OPEC discipline, reports from tanker-tracking firms using new, objective tools to measure trade flows paint a different picture. Apart from Saudi Arabia, the data suggests that OPEC has yet to significantly reduce exports regardless of whether production has been curtailed. Persistently high levels of OPEC supply would actually go a long way toward explaining the market's lingering state of oversupply. That is not to say that shale oil does not represent an existential threat for OPEC – and others – down the line. In the short term, though, things may not be quite as dire as they seem – if only the group dialed down its triumphalism.

OPEC's return to supply management last year has been a masterpiece of market messaging. To broker a deal between OPEC as well as Russia and 10 other non-OPEC producers, Secretary General Mohammed

Barkindo engaged in an unprecedented, well-publicized round of shuttle diplomacy. Far from being restricted to oil ministers, the discussions, for the first time, directly involved heads of state, from King Salman to Vladimir Putin. Mr. Barkindo and some of the group's others leaders took to referring to the accord as 'historic,' and had no trouble getting reporters to follow suit. Smart innovations were adopted to foster the deal's credibility. A compliance committee, led by both OPEC and non-OPEC representatives, was tasked with monitoring implementation. In an apparent bid to further convey the group's hands-on approach and hard-nosed determination, Barkindo singled out bringing down OECD crude stocks to their five-year average as a key target – a highly visible, concrete, verifiable benchmark by which to measure its success – when he was talking to market participants. No one seemed to mind that the compliance committee's non-OPEC leader, Russia, had a track record of spectacularly failing to deliver on past pledges to cut supply.

Indeed, since the production cuts went into effect, the group has gotten high marks for production discipline not only from itself but from other institutional market watchers such as the International Energy Agency, as well as bank analysts. The response from oil markets has been more tepid. Oil prices thus far have failed to rise over the $50 per barrel mark for a sustained period, and this has become a source of growing producer frustration and concern and fueled the perception that shale production growth is unstoppable.

Supply estimates from the IEA and others are not based on hard evidence, though, but largely rely on traditional techniques of news gathering, such as compiling anecdotal evidence and soliciting information from producer country officials, oil industry executives and other market participants supposedly in the know. Many sources provide information on condition of anonymity. To a large extent, the resulting estimates are ultimately based on self-reporting by inherently biased industry participants and are not objectively verified. Once a particular narrative takes hold of the market, market analysts can function as an echo chamber, reinforcing each other's misconceptions.

Recently, however, new methods of data collection have appeared that are based on tanker tracking technologies, satellite imagery and mathematical algorithms and are more objective than estimates from traditional market sources. Those provide fresh insights into trade patterns and shed new light on long-opaque energy markets.

One of these firms, ClipperData, presented its findings at an industry conference in Athens last week. According to its research, OPEC loadings only started to show a meaningful decline across the board in May. April loadings were at a peak, and overall shipments since January have failed to indicate any significant drop compared to October levels, the reference month for the agreement.

Exports were not uniformly elevated. Until May, Saudi Arabia stood out for its steep cuts in crude oil exports. But other Persian Gulf exporters kept shipments surprisingly high. The data suggest that the UAE did not meaningfully cut exports except for a single dip in loadings in March. For Kuwait and Qatar, it was business as usual. Angola did not cut, and indeed overtook Saudi Arabia as the largest exporter to China for two consecutive months, the data suggest. Russia, which had pledged to participate in the OPEC cuts, and earlier this month joined Riyadh in openly supporting an extension of the supply deal, showed a slight reduction in loadings in January due to ice and bad weather on the Black Sea, but exports have since recovered and surged to a peak in April.

This is not an assessment of actual field production, which others, in line with OPEC experts, have claimed showed exceptionally high levels of compliance with the production deal. Exports are generally assumed to broadly track production level, though. Regardless of production levels, OPEC's success in conveying a narrative of market control since last fall seems at variance with its impact on physical crude supplies.

OPEC's suggestion that its cuts be measured by changes in OECD oil stocks sounded like a good idea at the time, one that built confidence in its determination to nurse oil markets back to health. This might have been ultimately ill-advised, however. The most closely watched OECD crude oil stocks are those in the United States – including those at Cushing, Oklahoma, the delivery point of the NYMEX crude futures contract -- which are assessed weekly, more frequently than those in any other country except Japan. U.S. stocks are no longer the barometer of market conditions that they used to be, however. Various factors are increasingly lifting them above historic levels. Rising shale production has gone hand-in-hand with a build up of inventories needed for crude-gathering, blending (to ensure stable assays) and distribution purposes. Tighter integration of Western hemisphere markets, in particular spectacular growth in US refining and US refined product exports to Latin America, require US refiners to hold higher inventories than was previously the case. High supply disruption risks and diminishing output from short-haul heavy oil suppliers Mexico and Venezuela also call for higher stocks as a safety cushion.

Perhaps even more importantly, the lifting of the US crude oil export ban has turned the US Gulf Coast into the world's best parking lot for crude oil and encourages a striking divergence in inventory trends between the United States and the rest of the OECD. US crude stock builds gained traction in 2015 when US crude oil exports started rising, initially in piecemeal fashion, then accelerated after US crude oil export restrictions were altogether lifted in December 2015. Until then, US tank farms, despite ranking among the world's lowest-priced oil storage facilities, were akin to the Hotel California of pop-music lore: you could check your crude in the county's tank farms, but you couldn't check it out again. This greatly limited demand for US storage. The lifting of the export ban changed all that by letting market participants 'park' their crude in the US without fear of being unable to re-export it outside of the United States.

OECD also only represents part of world storage. Outside of the OECD region, oil inventories remain extraordinarily opaque. While oil stocks in the US and elsewhere in the OECD are relatively well captured in government statistics, such is not the case in most emerging markets. And while oil markets may be global, incentives to put oil in storage vary region by region. Changes in US or OECD oil stocks thus may not be taken as a reliable measure of global oil balances, let alone of OPEC's supply.

The apparent discrepancy between reports of stellar OPEC compliance and persistently high OECD stocks have encouraged a growing sense of shale's unstoppable rise. Here too market perceptions diverge from reality somewhat. Several years of upward revisions to shale supply growth estimates have worked their way into supply models, feeding expectations of exceptionally strong production growth for 2017. While the US shale oil rig count has been on a tear in recent months, and while the shale oil production cycle is shorter than that of conventional oil, there is still is significant lag from investment to production. Increases in well permitting, pad preparation and drilling activity may take longer to translate into actual shale oil production growth than many market watchers realize. It may also be risky to extrapolate from the shale industry's steep strong productivity performance of recent months. Some of the factors that led to these gains, such as high-grading, i.e. focusing activity on the most prolific plays, are inherently hard to scale up. Production costs are

already reported to be on the rise. Bottlenecks are emerging, and one of the most dynamic companies recently issued corporate guidance cautioning planned production increases would take longer to materialize than many investors might reckon.

This all suggests that OPEC's predicament might not be quite as daunting as it seems – at least in the short run. There are other encouraging signals. The market is showing signs of rebalancing, albeit slowly. As noted, May loading did fall for the first time in a big way, according to tanker tracking data. After more than a year of strong exports, Iran production appears to be running out of steam. High Iranian exports to date seem to have come in part out of floating storage rather than actual production. Since the lifting of international sanctions against Iranian oil exports in January 2016, Tehran has sought to maximize export revenue, but its production growth may not have lived up to expectations, and depleted floating storage could set the stage for slowing Iranian export declines, even though Tehran was exempted from the cut agreement.

Tanker tracking data also show that Chinese and Indian crude oil imports have been extraordinarily elevated so far this year, suggesting great appetite for oil storage in those countries, whether for commercial or strategic purposes. Floating storage started to build up in northern China, suggesting tanks might be getting full, or simply reflecting logistical congestion. But imports, notably from Latin America and West Africa, have remained at record highs. US crude exports have also found an outlet in Asia, notably Singapore, thanks in part to logistical innovation and co-loading of residual fuel oil and crude oil on VLCCs that have driven shipping costs down.

Thus, things are looking better for OPEC than the "shale vs. sheiks" indicates. But the group's self-congratulation on compliance sends the wrong message. That narrative, taken at face value, leaves it no choice but to double down on counter-productive cuts and ultimately relinquish market share to shale oil, or deliberately flood the market and brace itself for another round of price declines. Acknowledging gaps in compliance and calling for stricter discipline, far from being an admission of weakness, might paradoxically boost market confidence in OPEC market power and support a faster price recovery. At the end of the day, OPEC still has more firepower than its own narrative would suggest.

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