How OPEC is defying the doubters

Skeptics have been proved wrong, says Herman Wang—so far

When OPEC agreed in late 2016 to institute its first supply cuts since 2008, cynics scoffed that the organization's own inability to maintain any semblance of production discipline in previous hyped output agreements would be its own undoing.

Adherence to quotas would quickly unravel, they said, as it has in the past, and the resultant rampant cheating would inevitably lead back to a market share battle, with members pumping at will and crashing prices.

Eleven months into the deal, however, OPEC—along with the 10 non-OPEC producers led by Russia that agreed to join its output cut efforts—appears to be proving the doubters of its commitment wrong, so far.

The deal calls on the 24 participating countries to cut a combined 1.8 million b/d, in a bid to induce draws from oil in storage and rebalance the market.

Compliance with the quotas has been robust, coming in at 120%, a five-country monitoring committee reported in October.

"We hope this will put to rest, once and for all, any skepticism," OPEC Secretary General Mohammed Barkindo said at an industry conference in London.

Independent OPEC watchers largely back up the claims. S&P Global Platts, one of six secondary sources used by OPEC to monitor output, has pegged the organization's compliance with the deal through September at 106%, with Saudi Arabia, Venezuela and Angola, among others, cutting beyond their required amounts to make up for less complaint members, notably Iraq.

So, OPEC and its 10 non-OPEC partners have been able muster the discipline to control what they can control, for now at least.

But factors outside of the coalition's command bear watching as the output cuts continue into 2018. Namely, will US shale production, buoyed by rising oil prices in the third quarter, surge and undo the OPEC/non-OPEC cuts?

And will global oil demand grow in 2018 as forecast, helping soak up any additional supplies that come onto the market?

On the second point, OPEC ministers are bullish. The International Energy Agency in October projected 1.4 million b/d of new demand in 2018, though it said most of that would be offset by non-OPEC production growth, keeping a ceiling on prices.

Saudi energy minister Khalid al-Falih has called the IEA's demand forecast "conservative," noting that oil demand had increased by about 5 million b/d since the downturn in oil prices.

"Demand is a lot more resilient than many people want to admit," he said at the Future Investment Initiative conference in Riyadh. "If you look at the last three years ... once prices came down from the three-digit range, we saw demand increasing measurably, and, dare I say, significantly."

As for shale, the Energy Information Administration has forecast that by the end of 2018, US oil output would climb from the current 9.49 million b/d to 10.17 million b/d, with 490,000 b/d of that growth taking place in onshore shale plays.

"Based on our observations of current drilling and our price expectations, the forecast continues to project that US crude oil production in 2018 will top the 1970 annual production record of 9.6 million b/d," EIA Acting Administrator John Conti said in a statement. On this front, OPEC is again singing a bullish tune.

Banks and funds financing much of the projected growth in non-OPEC production would be unlikely to risk much more capital at current price levels, said Barkindo, who has urged US shale producers—or their financiers—to show more restraint and demonstrate a "shared responsibility" for oil market stability.

"You cannot have your cake and eat it," he said. "Hence we are beginning to see some of them coming out to say we have to be mindful of fiscal discipline. The funding they are getting from Wall Street is not continuing at the pace and level that they were getting."

"Considerations are gradually moving from volume to value. No producer is immune from the negative consequences of this cycle. They are beginning to ask themselves pertinent questions on how to proceed in a more responsible manner."

Time will tell, of course, and market fundamentals—to the extent that they will determine whether OPEC's strategy has been successful—do not become fully apparent until months after the fact.

The buy-in of Russia and the other non-OPEC producers boosted their collective share of the global oil market to more than 50%

Geopolitical considerations

Geopolitics will also have a role to play, as they often do in oil and OPEC.

The economic and political crisis in Venezuela is weighing heavily on its oil industry, with the country's crude production haven fallen almost 200,000 b/d in 2017 so far, according to the Platts OPEC survey.

Iran's crude exports may also be at risk, with US President Donald Trump threatening to promulgate sanctions on Tehran, following his declaration in October that Iran was not complying with the terms of the nuclear deal, which relaxed restrictions on its oil sales. Iran has boosted its crude exports to some 2.2 million b/d in recent months from the 1 million b/d while sanctions were in place from 2012 until January 2016.

In Iraq, the fallout from the Kurdish independence referendum, which had Turkey threatening to cut off the Kurdistan Regional Government's crude exports through the Turkish Mediterranean port of Ceyhan, must still be sorted, including agreements on oil revenue sharing between the KRG and the federal Iraqi government.

Elsewhere in the Middle East, the continuing economic embargo of Qatar by fellow OPEC members Saudi Arabia and the UAE, along with Bahrain, Oman and Egypt, shows no sign of resolution. Though the impasse has yet to impact Qatari oil and gas production, an escalation could put their status in doubt.

Within Saudi Arabia, its much ballyhooed public listing of state oil company Aramco—which officials insist remains on track for 2018, despite rampant speculation it could be delayed or even replaced by a private placement—could significantly change how the country views its long-term role in the market, as it seeks to diversify its revenue streams away from oil.

Ties with Russia

Amid the uncertain future, OPEC is keen to build upon its ties with its non-OPEC partners, particularly Russia.

The production cut agreement would not have nearly been as impactful without the buy-in of Russia and the other non-OPEC producers, which gave OPEC some allies that boosted their collective share of the global oil market to more than 50%.

Saudi King Salman in October made the first state visit by a Saudi monarch to Russia, when he met with Russian President Vladimir Putin in Moscow, in a warming of ties between the world's two largest oil producers that observers said augers well for their continued efforts to manage the market, at least in the near-term while prices remain depressed.

"An agreement between Russia and a number of other countries with OPEC is a good example of cooperation," Putin said after the meeting. "We've not only ensured stabilization of oil markets but new opportunities are emerging for realization of new projects because investments are returning to the sector."

Iranian president Hassan Rouhani likewise traveled to Moscow in March for a meeting with Putin.

Barkindo said that OPEC was hoping to create a "permanent framework" to sustain the relationship that the organization has with Russia and the other non-OPEC participants in the output cut deal, even after that agreement expires.

The deal has made progress in reducing the oil market's supply overhang, he declared, but with more work to be done and an increasingly competitive landscape, cooperation among producers in the interest of stability remains paramount.

The high compliance with quotas, under the leadership of Saudi Arabia and Russia, was evidence of the goodwill and trust among the coalition, he added, and more countries would be welcome to join.

"This platform of 24 countries, now hopefully growing, should be institutionalized," Barkindo said. "It is about how to sustain this [market] balance. Hence, the call on us to construct a more institutional framework. We are working with the Russians and Saudis on how we can structure this platform to sustain it." ■