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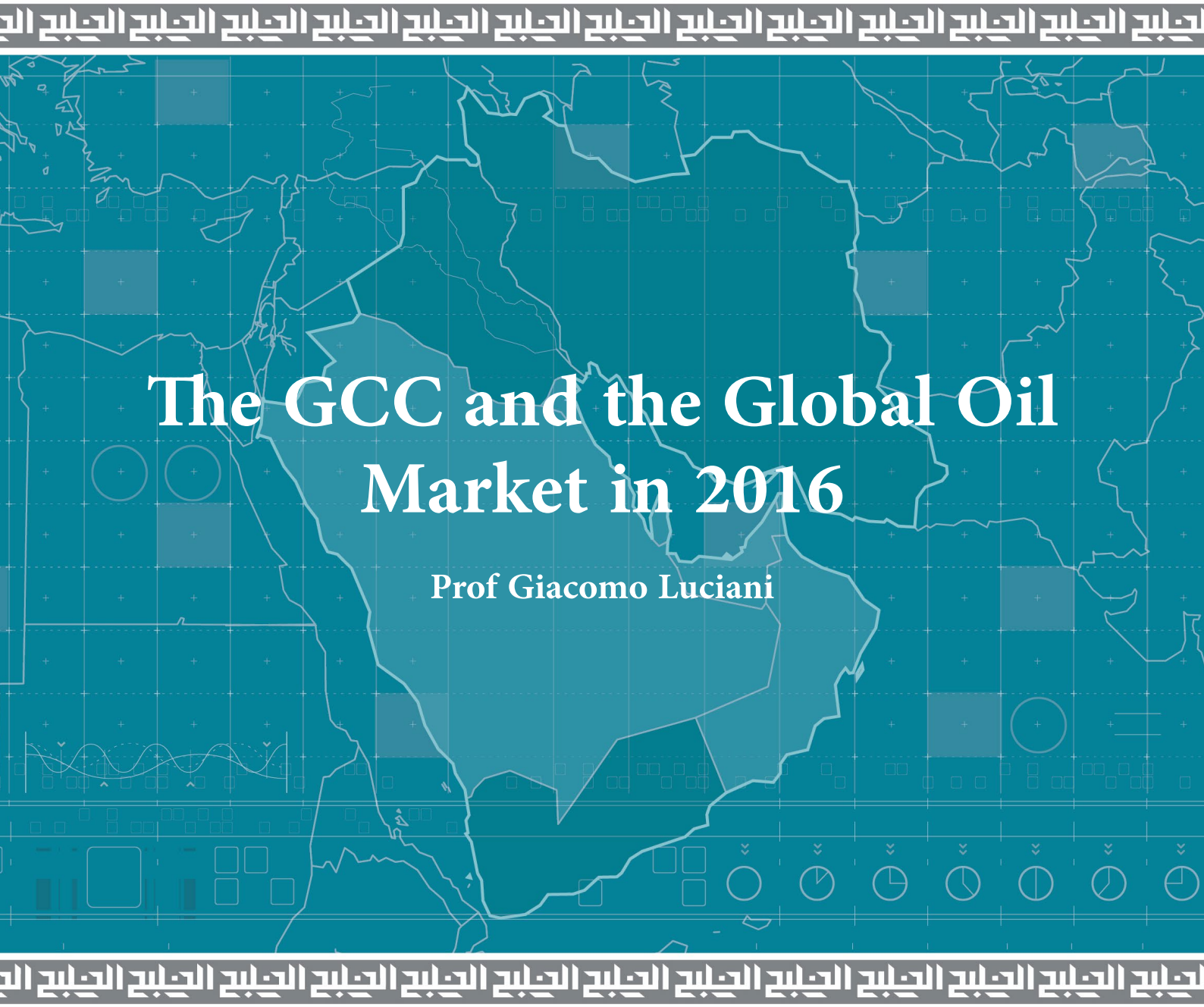

The GCC and the Global Oil Market in 2016

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The complex birth of the November 30th agreement within OPEC, and between the latter and some non-OPEC major oil exporters, was the salient oil market event of 2016. The agreement aims at limiting production and stabilizing the global oil market, with the hope that prices might increase somewhat, thus improving the distressed financial conditions of most oil exporting countries. Prices fell in January 2016 to a low of less than 30 $/bl, the lowest price in more than a decade, then recovered gradually, increasing by nearly one hundred percent to55$/bl towards the end of the year. Nonetheless, during the first half of 2014, prices had been well above 110 $/bl: hence 2016 saw a decline of 50 percent relative to two years earlier.

As for all the complex negotiations, commentators have asked which country may be said to have "won" and which to have "lost." Regarding OPEC, does this represent a return to the fore or the beginning of the end? And what consequences may the agreement have?

Winners and Losers

The market had expected OPEC to intervene to shore up prices in 2014 and 2015, but both times Saudi Arabia refused to accept the compromises that were then on the table. From the beginning, the Saudi line has been that the Kingdom would only participate in collective action if other major exporters, including major non-OPEC members, would also significantly cut their production. In other words, the Kingdom never excluded the possibility of cutting production to sustain prices, it simply refused to do so in isolation, or if all other major producers refused to share the burden. In 2014 and 2015, it was very clear that other major producers were not ready to share the burden. Three countries in particular were crucially important: Iraq, Iran, and Russia. Iraq had been exempted from quotas ever since the imposition of sanctions in the 1990s and was refusing to accept new quotas. Iran was producing well below its nominal quota because of sanctions, and claimed that cuts should be accepted by countries that had "stolen" its market share, i.e., had increased their production compensating for the fall in Iranian production. Russia is outside OPEC and declared that it was not ready to limit its production at all.

The position of all three countries significantly evolved during 2016. It should be noted that all three, and Saudi Arabia as well, significantly increased their production during the year (see table 1). This allowed them to be more flexible in search of a compromise while at the same time claiming to have not given up on their respective market shares.

With the exception of the United States, all major producers increased their production in 2016, albeit at variable paces. The recovery of production in Iran following the suspension of European sanctions in January was much more rapid than expected, and allowed Tehran to accept a freeze (in fact, a small increase) rather than insisting on recovering their full quota. Iraq also accepted a more

substantial cut, and Russia did the same. Thus, although Saudi Arabia's cut is larger than other countries', in the end the Kingdom obtained a pledge from all major producers, except of course the United States.

Table 1: Change in crude oil production in select major countries, October 2015 to October 2016, thousand barrels per day	
United States	-486
Canada	+205
Brazil	+256
Norway	+114
Saudi Arabia	+274
Iran	+823
Iraq	+587
Kuwait	+200
UAE	+182
Russia	+489
Source: Petroleum Intelligence Weekly	

From another point of view, however, it is unclear whether the Saudi strategy truly succeeded, and this is mostly in connection with US shale oil production. Throughout 2010-14, US oil production climbed by 4 million barrels per day. It peaked in June 2015 at 9.6 million barrels per day, then declined and touched a minimum of 8.45 million barrels per day in the first week of October 2016. But from that trough it promptly recovered, and by the second week of December 2016 it was back at 8.8 million barrels.

These figures tell us that US shale oil production has demonstrated much greater resilience than was expected in 2014, and this undoubtedly took Saudi Arabia and the other major GCC producers by surprise. When in 2014 it was decided to go for market share, it was expected that US shale oil production would decline rapidly as prices approached 50 $/bl. Instead, shale producers were able to reduce costs and maintain production in most cases. We shall never know whether a continuation of low prices would have caused a more serious reduction in US production; the fact is that in the game of chicken Saudi Arabia decided to swerve. Considering that the US truck is pilotless – in other words, there is no authority willing or capable of influencing US oil production – the Saudi decision may well be regarded as prudent.

The Role of OPEC

Following the failure to reach an agreement in November 2014, OPEC had been proclaimed dead for the umpteenth time. Now in the light of the agreement in November 2016, has it recovered its historical role?

It is clear that OPEC as an organization suffers from lack of cohesion and authority over its member countries. In essence, OPEC can decide to take action only if Saudi Arabia agrees to do so, and the effectiveness of the organization boils down to whether Saudi Arabia and other major members can reach a compromise. Most recently, the position of some historically important members, like Venezuela, proved to be almost irrelevant. Although the Algerian Minister Noureddine Boutarfa played a useful mediation role, the only truly significant players were Saudi Arabia, Iran, and Iraq. At the same time, OPEC is also unable to take action in the absence of a broader consensus encompassing a select group of non-OPEC countries, under the leadership of Russia.

The current situation may therefore be described as one of de facto dual governance, in which OPEC and the non-OPEC group at times agree to pursue a certain common

action. In the absence of such an agreement, OPEC is too weak to move on its own. There are numerous questions that remain unanswered, and cohesion within OPEC does not strike the observer as being tighter than in the non-OPEC group. It is not clear why non-OPEC countries do not join the organization; they mostly enjoy observer status and do not pay dues, but the latter is hardly a sufficient reason to stay out. Does Russia believe that it has more of a bargaining power by staying outside of OPEC? In fact, any substantial action requires first and foremost an agreement between the two major producers, i.e., Saudi Arabia and Russia, and arguably the turning point in 2016 only occurred when Russia officially stated that it was ready to cooperate with OPEC. If such an agreement is possible, the chances of an agreement within OPEC are also enhanced. Thus, in a sense Russia is a determining factor of cohesion within OPEC.

In the new situation, the only truly non-OPEC – or anti-OPEC – country is the United States. The US government does not have the legal tools to influence the level of production, except indirectly, i.e., through opening or closing federal lands and offshore areas to exploration and production, or imposing more stringent regulations on the industry. But these tools are not very effective, and public opinion is totally against any suggestion that oil production ought to be limited or prices ought to be higher.

As was noted already, Saudi Arabia failed to slay the shale oil dragon; it only managed to inflict some wounds and weaken it, but the dragon remains alive and ready to jump back center stage.

Are Oil Prices Likely To Increase?

Any discussion on the likely impact of the OPEC-non-OPEC agreement requires an analysis of the role of oil stocks and of the forward price curve on the oil futures market. It also requires assumptions about the actual implementation of what has been agreed over the entire duration of the short, six-month agreement (although extensions are possible).

Over the past six years at least, global oil supply systematically exceeded demand, and very large volumes of oil accumulated in storage. These stocks are held either by private or public actors, and may be either commercial or strategic. The latter in theory are not expected to be used for market intervention, but the boundary between the use of stocks for strategic purposes as opposed to market intervention is extremely uncertain.

We do not have a clear estimate of oil in storage: not all countries report how much oil is held in storage on their territory, and, in addition, some oil is stored on tankers that may be anchored or making slow progress towards an undefined destination, or in storage facilities that are legally offshore or in free trade zones and not subject to the jurisdiction of the host country. We only have a good understanding of stocks that are held by the IEA member countries; the Agency regularly publishes information about available private and public stocks measured in number of days of net import requirements. As of September 2016, the Agency estimated the total oil stocks of its member countries at 280 days of net imports, of which 170 days were held by the industry and 110 by public entities. The long-standing policy of the Agency has been that member

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The privately-held owner of stakes in thousands of U.S. wells added hedges on Dec. 1 and 2, immediately after OPEC announced its production cut, according to Katherine Richard, chief executive officer at the Oklahoma City-based company.

"I have over 200 wells currently drilling and I want to lock in my 20 percent-plus internal rate of return," Richard said. "I hedge to lock in the prices that undergirded my drilling approval decisions."

The latest surge in prices extends U.S. shale drillers' pattern of adding hedges when crude rises into the mid-$50s. Pioneer Natural Resources Co., for example, said in early November that it increased its hedges for next year to 75 percent of production from 50 percent. In the third quarter, Devon Energy Corp. more than quadrupled its 2017 positions from the prior three months.

How Shale Oil Firms Ramped Up Hedging After OPEC Algiers Rally

WTI oil prices gained 12 percent last week -- the biggest weekly gain in almost six years -- after OPEC announced its cut and Russia promised to reduce output too. WTI ended Friday at a 17-month high of $51.68 a barrel. It rose as high as $52.42 Monday.

https://www.bloomberg.com/news/articles/2016-12-05/oil-market-turns-upside-down-as-shale-rushes-to-hed

The bottom line is that prices are unlikely to increase much further or in line with the expectations of OPEC and non-OPEC producers.

countries should hold the equivalent of at least 90 days of net imports in order to be able to withstand possible supply emergencies, although no emergency ever required recourse to such large stored volumes. In any case, at present, the level of stocks is way in excess of what the Agency requires. Considering that OECD oil imports in 2015 have been 17.8 million barrels per day on average, the industry-held oil in storage in the IEA countries should total some 3 billion barrels. Obviously the global figure must be higher.

We can visualize oil in storage as being contained in one huge global tank, into which daily oil production is poured, and from which daily oil consumption is subtracted. In other

words, the balance of supply and demand is not immediate: if supply exceeds demand, the level of oil in storage increases; and if demand exceeds supply, the opposite takes place. The agreement to cut production between OPEC and non-OPEC countries aims at restricting supply by a total of 1.8 million barrels per day. Assuming that when the agreement is implemented supply and demand are exactly balanced, it would take more than 800 days, i.e., longer than two years, to reduce the level of IEA industry-held stocks by half.

However, as of end 2016 supply continues to exceed demand, and oil is still accumulating in storage. The IEA believes that equilibrium of supply and demand may be reached in the first semester of 2017, OPEC is less optimistic and expects equilibrium to be reached in the second semester. I argue that equilibrium in itself does not necessarily indicate a shortage of oil; it simply suggests that oil in storage will begin declining. Before markets can feel any tightness of supply, oil in storage will need to decline for an extended period of time.

The forward curve of futures prices is important because it governs the accumulation or decumulation of oil in storage. For operators to be willing to hold oil in storage, it is necessary that prices at some more distant future date be higher than prices in the close future (i.e., front month prices – the ones that are normally referred to). If the forward curve is upward sloping, i.e., prices for subsequent months are higher than prices for the front month, the market is said to be in a contango, and it may be profitable to hold oil in storage. If this is not the case, holding oil in storage is a losing proposition and operators will seek to liquidate or reduce their stocks.

In fact, the market has been in a contango since 2014, and accumulation of stocks has been encouraged. However the OPEC-non-OPEC agreement of November 2016 has raised the curve enough to encourage US shale oil producers to resume hedging their production. Although front month prices are not very high, prices for six or nine months thereafter, or even more distant time horizons, are more interesting. For example, on December 1, the January 2017 price of WTI was 3.5 dollars less than the July 2017 price. Shale oil producers can sell at the more distant future prices and guarantee themselves a better profit than selling at prompt prices. This helps explaining the resilience and recent increase of shale oil production in the US.

But the increase in futures sales also has the effect of flattening the forward curve – unless the market is very bullish about prices in the coming months. In turn, a flatter curve indicates reduced incentive to hold oil in storage. Hence, at the moment, US shale oil producers are both increasing their production and discouraging further accumulation of stocks.

Will the Agreement Hold?

The scenario is therefore one in which the agreement to cut production will need to be faithfully implemented by all concerned producers over a period much longer than the six months of its current validity before prices can be expected to move significantly higher. At the moment, the market appears to believe that the agreement will succeed, but to some extent this is a manifestation of wishful thinking – everybody except final consumers wishes prices to be higher. Such confidence may quickly dissipate if US oil shale resumes rapid growth or weaknesses are detected in the implementation of the agreement. In light of past experience, it is highly likely that the agreement will not be watertight: a significant potential source of weakness is that both Libya and Nigeria have not been included in the new quotas because their production is currently much below their previous quota due to political turmoil and insecurity. Nevertheless, a recovery is possible and would raise problems for the credibility of the overall production cuts.

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