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The Art of the OPEC Deal

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On its face, OPEC's meeting marathon in Vienna last week – including the 7th OPEC International Seminar, the 174th Meeting of the OPEC Conference and the 4th OPEC and non-OPEC Ministerial Meeting -- was a show of strength by a resurgent organization whose obituary had been written by many analysts after the price collapse of 2014, and which is now evidently rejoicing in its vitality. A feeling of mission accomplished was in the air as the ministers took stock of the market rebound since the "Declaration of Cooperation" (DOC) of December 10, 2016 that saw its member states and their non-OPEC partners, led by Russia, create what turned out to be a highly effective program of production cuts. A heavy dose of ceremony was on the menu, including a dance show by cheerleaders waving LCD batons programmed to show the flags of the member states -- and Russia's. Behind the glitz, there was also a fair amount of backroom dealings, ending on a high note with an agreement to lift production by an unspecified amount, a move hailed by most market commentators as a significant achievement and a welcome supply injection in an oil market increasingly perceived as at risk of overheating.[1]

On closer look, however, there were fine worry lines behind the Organization's confident smile. OPEC's dalliance with Moscow, often identified as a historic development and a key factor behind the group's re-empowerment, may be more problematic than it seems. OPEC's president opened the meeting with a tantalizing teaser (echoed by Saudi Prince Abdulaziz bin Salman) that it would not be adjourned before unveiling some kind of permanent formalization of the Russian partnership that the meeting somewhat predictably failed to deliver.

The decision to increase production also marks in some ways an important departure from previous agreements. OPEC meetings tend to be backward-looking, reactive affairs, where ministers look in the rearview mirror and try to fix yesterday's problem. This move, in contrast, was uncharacteristically forward-looking, and, although it was not explicitly stated, seemed partly intended to blunt the price impact of the Trump Administration's renewed sanctions on Iran. While this proactive stance may be good news for the market, it also risks making OPEC an accessory of US policies against one of its members. That would be less of a problem had Washington's foreign policy stance not become so seemingly erratic and unpredictable. While President Trump's hostility

to Tehran has been consistent and unwavering, there is still a great deal of uncertainty as to the fine print of his Administration's sanctions policy and how rigorously it will seek – or manage – to enforce unilateral sanctions. This unpredictability represents an unprecedented political risk for OPEC and will pose a challenge to its leaders as they attempt to maintain good relations with Washington, offset supply disruptions, project an image of responsible supply management and portray the Organization as an agent of market stability.

Replacing Iranian barrels

To be sure, the production hike agreed last week was not meant to fix a current imbalance – of which there is no obvious sign in the market today. Rather, the decision appears to preempt a future one – in particular, a hard collapse in Iranian exports as a result of Washington's decision, announced in early May, to leave the JCPOA – and assuage market concerns about a looming supply gap expected to result from reduced Iranian exports. It is perhaps no accident if the US Department of State, which had previously refrained from issuing any guidance as to how it intended to enforce the sanctions, shortly after the OPEC meeting signaled its goal of reducing Iranian oil exports to zero by early November, according to a briefing held in Washington on June 26. On June 25, the US Government also reportedly started reaching out to importers of Iranian oil to discuss the sanctions. The OPEC meeting's main achievement may have been to clear the way for Arab Gulf countries and Russia to fill the gap left by Iran's forced exit and grab its market share, thereby keeping price hikes to a minimum.

The language of the two OPEC communiques of June 22 and 23 is unusual. Both documents noted that the group had reduced output beyond the levels agreed in November and December 2016. It is not often that OPEC's problem is one of over-compliance with production cuts as opposed to under compliance. OPEC reckoned it had overshot by half in May ("OPEC Member Countries have exceeded the required level of conformity that had reached 152%"), and almost as much if all DOC signatories are included ("countries participating in the DOC have exceeded the required level of conformity that had reached 147% in May 2018"). The group's stated goal is thus to lower compliance back to 100% by July 1. While no specific volumetric targets were put on paper, Saudi Oil Minister Khalid al-Falih talked informally of a hike of up to 1 million barrels per day (bpd), the same amount as that reportedly being sought by Trump Administration officials prior to the meeting.

Another issue left unresolved by the documents is the allocation of production increases among participants. Less than a handful of OPEC producers – namely Saudi Arabia, Kuwait and the UAE – have any spare capacity. Russia also has some leeway to lift its production. If the increase is prorated among DOC signatories, the actual level of incremental supply to be expected will be considerably less than the current 1 million bpd or so of overcompliance. Saudi Oil Minister Khalid

al Falih, however, made it clear in his comments in Vienna that the group intended to go back to compliance collectively, rather than individually. That opens the door for Riyadh to fill the gaps left by production declines elsewhere – or sanctions. The deal can thus be interpreted as an unspoken redistribution of production quotas among OPEC members – and an implicit license for the few remaining owners of spare capacity to take over their partners' market share.

Balanced markets

While oil prices have been rising, there is no clear sign of supply deficit or market imbalance just yet. Rather, the expectation of a future gap resulting from renewed sanctions on Iran appears to be supporting prices, compounded by a forecast slowdown in shale oil supply growth due to Permian pipeline constraints. Collapsing Venezuelan production – the main cause of OPEC over-compliance – has eaten into OPEC's market share, but as far as the global market is concerned, this has been more than offset until now by stellar growth in US shale oil. While prices have increased in anticipation of future tightness, time spreads have not firmed up as much, an indication that current market balances remain comfortable.

If the goal of OPEC had been to maintain market share, the decision to ramp up output would have made perfect sense. Game theory suggests the group's sweet spot, to fully leverage the benefit of high-cost non-OPEC production, is a market share of about 42%.[2] OPEC's share had dropped below that by the time of the price collapse of 2014, when then-Saudi Oil Minister Ali Naimi surprised the market by leading OPEC into switching from a policy of price support to one of going for market share. It had recovered when his successor, Khalid al-Falih, pulled the stops on production growth. It has since fallen back again under the twin pressure of collapsing Venezuelan supply and surging shale output. Unlike in 2014, however, the (re-) conquest of market share last week has not been acknowledged as the group's explicit objective.

If the objective of the agreement had been to bring supply and demand in balance, then the deal would exceed the needs of current market conditions. The International Energy Agency's latest *Oil Market Report* shows the oil market in perfect equilibrium in the first quarter of 2018, with OPEC production estimated at 32 million bpd, flush with the estimated call on OPEC. For the second quarter, the IEA detected a small dip in the call, down to 31.9 million bpd, while production fell farther, to 31.64 million bpd in April and 31.69 million bpd in May, roughly 200,000 bpd below the call. For the third quarter, however, the IEA projects a further 200,000 bpd dip in the call, back in line with current production levels, and a 400,000 bpd quarter-on-quarter bounce back up in the fourth quarter.[3] By this token, a nominal production hike of anywhere between 600,000 bpd and 1 million bpd effective July 1 risks giving back some of the rebalancing of the last two years.

It is, of course, possible to argue with IEA figures. But if anything, other data point to a looser market than the IEA suggests. IEA oil inventory data, which have a two-month lag and focus on OECD countries, or roughly half of the oil market, show steep, sustained draws, consistent with the notion of tightening fundamentals, culminating most recently with a counter-seasonal dip of 3.1 million barrel draw in April, down to a new three-year low. "Inventories have fallen in eight of the last nine months," according to the OMR. Satellite information covering global crude stocks for the last two months, the blind spot of official statistics, paint a different picture. Global crude stocks bounced back steeply through most of the last few weeks, in line with a softening of time spreads observed in crude future markets[4].

If refinery maintenance caused the crude builds, then they might prove that bearish as they would be offset by draws in product inventories not covered by satellite imaging. If so, however, product prices would have appreciated relative to those of crude, boosting refining margins. Yet refining margins have been sluggish in recent weeks, which hints at softening product demand and easing market conditions overall.

Thinking ahead

The risk of throwing more production at a market that appears to be already shifting into oversupply would be to force steep price drops, squandering the results of the product cuts of the last two years. That is, as long as current production conditions continue unabated. But a production hike is of course entirely justified under the assumption of steep supply shortfalls, such as would be caused by drastic cuts in Iranian exports.

The trouble comes with trying to assess the scope of future Iranian supply disruption. When the Trump Administration formally announced its decision to leave the JCPOA, how international importers of Iranian oil would comply with this unilateral re-imposition of sanctions was highly unclear. Compared to the three and a half years during which sanctions were imposed by the P5+1 on Iranian oil exports under the Obama administration, the differences were obvious: unlike in 2012-15, there is no broad international support today for Iranian sanctions. Until this week, there had not even been any conversations between Washington and its international partners on implementation, no guidance from the Department of the Treasury as to Washington's exact plans.

In addition, since the lifting of sanctions under the JCPOA in 2016, there have been substantial changes in the distribution of Iranian oil exports, which further cloud the outlook: OECD imports (from Europe, Korea and Japan) never went back to pre-sanctions levels, while China and India, which did not cut their Iranian imports as drastically as others in 2012-15, increased them more aggressively since then. Within these countries, new buyers have emerged that have less US exposure and thus may be less responsive to US pressures, such as the so-called teapot refiners in China's

Shandong province. It could therefore be argued that the Iranian sanctions would likely be less rigorously applied under Trump than under Obama.

In Vienna, however, the buzz among participants in the OPEC International Seminar was that such expectations were misplaced. European buyers have already dropped their imports, as have Korean importers, which have reportedly stopped buying not only Iranian crude oil, but even Iranian condensate, which had been exempted from the sanctions in the previous round. Indian importers are talking about sourcing alternate supplies. While governments may be upset about Trump's re-imposition of the sanctions and may not have officially agreed to comply, their support may not be necessary for them to be strictly implemented. Even before Washington provided guidance, insurance companies and banks had already sprung into action. The financial industry is terrified of falling foul of Washington and is taking a hard line on sanctions, reportedly making it extremely difficult for importers to finance and insure Iranian cargoes. Expectations are building that the implementation of the sanctions may be more rigorous, not less, than in the first round. Oil industry insiders are now expecting that Iranian oil exports could fall even more precipitously than they did in 2012 in the previous round. Condensate is no longer certain to be excluded from the sanctions.

Then came, after the OPEC meeting, the State Department briefing of June 26 announcing a goal of zero Iranian oil exports by November 2018 – an unreasonable target given the physical constraints and long lead time of oil trading and shipping, but certainly a more aggressive signal than anything under the previous administration. At the same time, Washington officials have let it be known that they have started reaching out to buyers about cutting imports, and to Arab Gulf producers about replacing Iranian barrels.

In such a context, it does not matter that crude stock built in the last two months. Seen against the backdrop of future supply shortfalls, rather than past surplus, OPEC's decision to comply with US requests for an output hike makes sense. Given the potential for future supply dips from some of its own member countries, OPEC as a whole might not be in a position to increase supply overall, but those OPEC producers with any spare capacity –Saudi Arabia, Kuwait and the UAE – will have to tap into it to make up for declines elsewhere. Depending on the pace of Venezuela's meltdown and what happens with Iranian exports, the Gulf producers' spare capacity might not be enough to calm the market, and a release of oil from the US Strategic Petroleum Reserve and/or other IEA emergency stocks cannot be ruled out.

Political risk

OPEC's accommodation of US call for production hikes is however not without risks. While this would not be the first time that Saudi Arabia lifts production to offset declines from other members, the latest decision to raise output could be seen by some as de facto acquiescence, from the planning

stage to Washington policies against one of the Organization's members. Such a move has no clear precedent in OPEC history -- including even the run-up to the second Iraq war, which Riyadh explicitly opposed. Moreover, while internal political divisions within OPEC countries are nothing new (think of the Iran-Iraq war), such conflicts are usually left at the door of OPEC meetings. This may be the first time that oil policy comes so close to giving the appearance of being enlisted in the service of internal conflicts. That could leave some scars.

Even more importantly, the daylight between Trump foreign policy announcements and their implementation raises the level of uncertainty as to the exact scope and effect of the sanctions. The Administration's move to set the bar at zero – in contrast with the Obama Administration's fudgier goal of a "significant reduction" and its exclusion of condensates – stretches credibility and sets it up for failure. It raises serious questions about its determination to enforce the sanctions. Is Washington serious about the measures, or is it just posturing? Is the goal to apply steady pressure on Iran, or is it shock and awe? In that case, the Administration might seek to not only cut off Iranian exports but also to lower oil prices by releasing SPR oil – thus hitting Iran's pocketbook twice, in both price and volume terms. The frequent disconnect between public posturing and practice exhibited by the current government may become a challenge for OPEC as it seeks to model its production plans on Washington's Iranian policy: if US targets cannot be taken at face value, how can OPEC avoid the risk of over- or undershooting?

To further complicate matters, OPEC's goal of cementing its alliance with Russia into a permanent, formal, institutional link appears predictably elusive. Observers noted Moscow's participation in the DOC as critical to the effectiveness of the last OPEC cuts. Riyadh and Abu Dhabi are anxious to consolidate this partnership and ensure that it survives a reversal of production cuts. Among other benefits, a formal alliance with Moscow would also strengthen the Gulf monarchies' hand vis-à-vis Iran. Yet while Russian oil interests, following the spectacular growth of its production in 2014-16 and the concomitant plunge in its production costs due to the devaluation of the Ruble, appears increasingly aligned in practice with those of Riyadh, Moscow seems unwilling to commit formally for the long term. Rather, it seems determined to keep its cards close to its chest and leverage any short-term alliance with Riyadh for all its worth. Where Riyadh, followed by Abu Dhabi, seeks commitment, Russia is intent on preserving optionality. Moscow may also be more interested in aligning its policy with Washington temporarily than with OPEC, in the hope of sanctions relief. Remarkably, the idea that Russia could become an associate member of OPEC (just as China became an associate member of the IEA) was expressed last week in Riyadh by Khalid al-Falih – not his Russian counterpart Alexander Novak.

Perils ahead

OPEC's achievements of the last two years have been truly remarkable. OPEC also has been extraordinarily adept at steering clear so far of the pitfalls of the current US Administration. The oil market may have been disappointed by the lack of specific production targets in its latest communique – reflected in the jump in prices following the news – but it was in fact wise of the Organization to adopt a wording vague enough to allow for some flexibility, and leave it room to adjust to potential swings in US policy. Past performance is no guarantee of future success, however. From concerns about peak oil demand and uncertainties about shale oil production growth to the unpredictability of Washington, the road ahead is a minefield. Uncertainty about US policy is a new challenge for oil producers. The Organization's display of institutional might last week may be as much a sign of strength as a brave attempt to disguise its vulnerability.

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[1] See, for example, HSBC Global Research, OPEC's united front, June 24, 2018. Market participants however were unimpressed by the announcement of a production hike and prices jumped on the news. See Benoît Faucon, Summer Said and Stephanie Yang, "Oil prices Jump After OPEC Deal to Lift Output," Wall Street Journal, June 22, 2018.
[2] See Jean-Michel Lasry, Antoine Halff and Antoine Rostand, *The Oil Games*, Kayrros, 2017-2018.
[3] International Energy Agency, *Oil Market Report*, June 13, 29018, pp. 16 and 49.
[4] Disclosure: The author is a founding partner of Kayrros, a provider of satellite-based energy data.