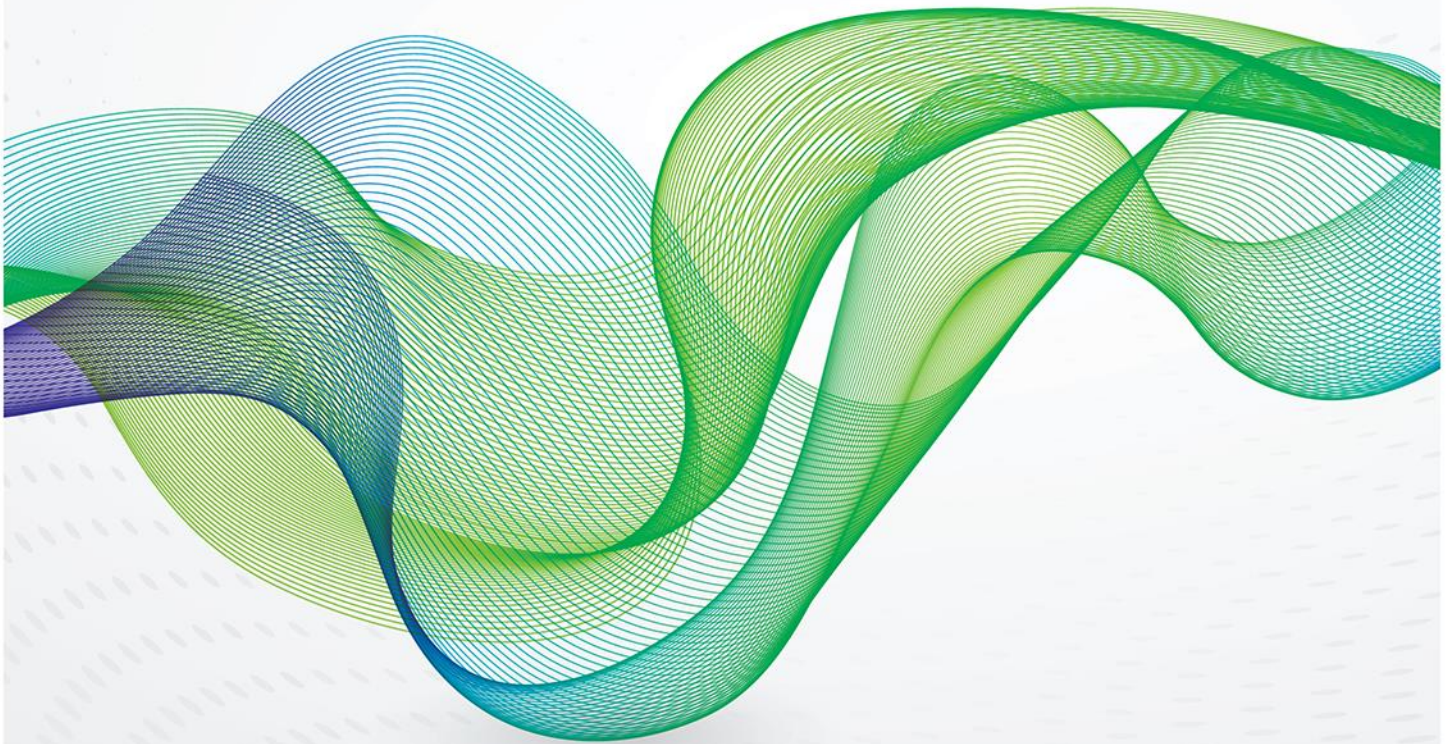




THE OXFORD
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OPEC Deal or No Deal? This is Not the Question



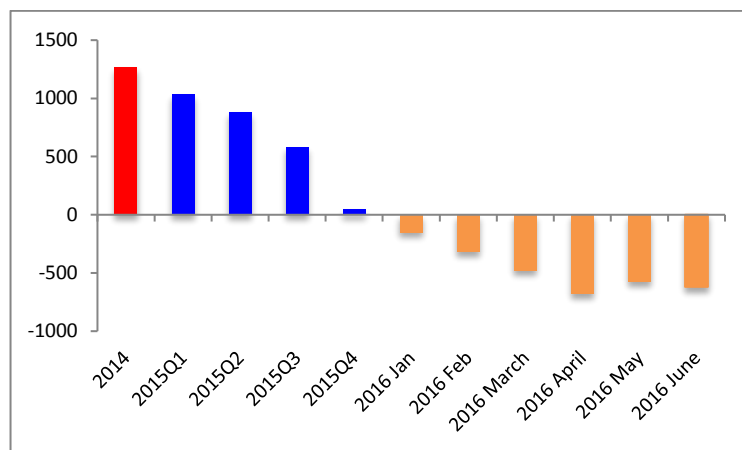
OXFORD ENERGY COMMENT

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I. Introduction

The shift in Saudi oil policy from pursuing a market share strategy to showing willingness to cooperate on an output cut or freeze has come under close scrutiny in recent weeks. Some have argued that this shift is a recognition by Saudi policymakers that their policy so far has been a ‘pretty comprehensive strategic failure’ due to ‘a mixture of hubris, inexperience and – most important – a failure to understand...how a genuine market economy works, which is why all the rhetoric about new economic plans for the country built on a fairy tale presentation from consultants is going nowhere’.¹ Others are of the view that Saudi Arabia has finally blinked, conceding defeat in its war against U.S. shale², despite the fact that US output has been in sharp decline since the start of this year (see Figure 1). Others argue that Saudi Arabia is in ‘financial crisis’ and in ‘panic mode’ and is therefore ‘desperate’ to reach an output deal with other producers at whatever cost³ and thus is willing to accept ‘much deeper and financially painful oil production cuts’.⁴

Figure 1: US Crude Oil Output, y/y change, thousand b/d



Source: EIA

While such accounts of Saudi oil policy tend to capture the public imagination, they are of very limited use for understanding the evolution of Saudi oil policy over time. They tend to see the world as static and in black and white (the defeat of Saudi Arabia implies the victory of US shale and Saudi Arabia’s desperation means that it could be cornered into a deal). These accounts also embody an implicit assumption that the fundamental principles that have guided Saudi oil policy so far - its unwillingness to act unilaterally; and that any shift in policy must be driven by higher revenues - have been abandoned altogether. Making decisions on the basis of such assumptions can be costly, as witnessed in 2014 when many in the market believed that Saudi Arabia would cut output to balance the market despite clear signals of its unwillingness to act as the sole swing producer. In the current context, because of ‘Saudi desperation’ and ‘Saudi defeat’ in the price war, one view gaining popularity is that Saudi Arabia will accept any deal regardless of the cost-benefit calculus. According to this view, the alternative to not reaching a deal is too costly for Saudi Arabia. Those in the market adopting this line of reasoning may be disappointed.

¹ Nick Butler, ‘The Saudis’ Strategic Failure’, The Financial Times, 10 October 2016.

² Bloomberg, ‘In U-Turn, Saudis Choose Higher Prices Over Free Oil Markets’, September 29, 2016; A. Herman ‘The Oil War Is Over, and We Won’, National Review, 6 October 2016.

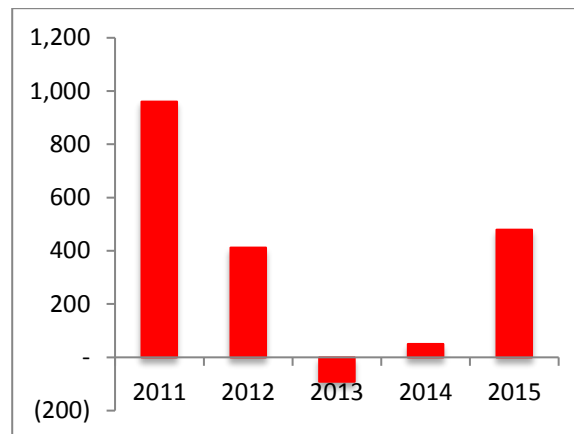
³ RT, ‘Oil soars as OPEC reaches deal to limit production first time in 8 years’, <https://www.rt.com/business/360988-opec-deal-limit-oil/>

⁴ Bloomberg, ‘Saudi Arabia Faces Tough OPEC Equation With Mounting ‘Exemptions’’, October 25, 2016.

II. The Three Phases of Saudi Oil Output Policy

Since the recovery of oil prices after the 2008 financial crisis, Saudi oil policy has passed through three distinct phases. In the first phase, between 2011 and 2013, Saudi Arabia played its preferred role by increasing output to offset supply disruptions elsewhere. In 2011 and 2012, Saudi Arabia's production increased by 0.96 mb/d year-on-year and 0.41 mb/d respectively, reaching 10.1 mb/d in August 2013, before output declined slightly below 10 mb/d towards the end of 2013 as supply disruptions eased (see Figures 2 and 3). These output increases were not enough to compensate for the supply outages and the market had to rely on the rapid increase in US shale oil to meet the supply gap. Saudi Arabia's oil production held steady at around 9.6-9.7 mb/d through to the end of 2014.

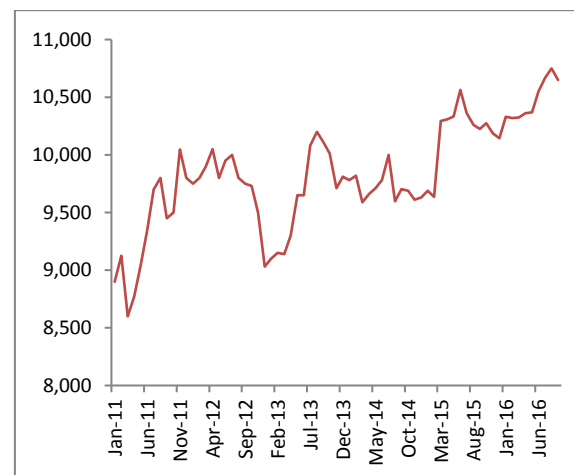
Figure 2: Saudi Oil Output, y/y change, thousand b/d



Source: Energy Aspects

Towards the end of 2014, Saudi oil policy entered a new phase when the Saudi oil minister at that time, Mr Ali Al-Naimi, took a decision to prioritise market share in the face of huge market imbalance and in the absence of any collaboration from other OPEC members and non-OPEC countries. Not ceding market share to high cost and inefficient producers was the motto of the day.⁵ This policy manifested itself in a surge in output with Saudi production reaching 10.3 mb/d at the start of 2016, with year-on-year growth in 2015 reaching close to 500,000 b/d.

Figure 3: Saudi Oil Output, thousand b/d



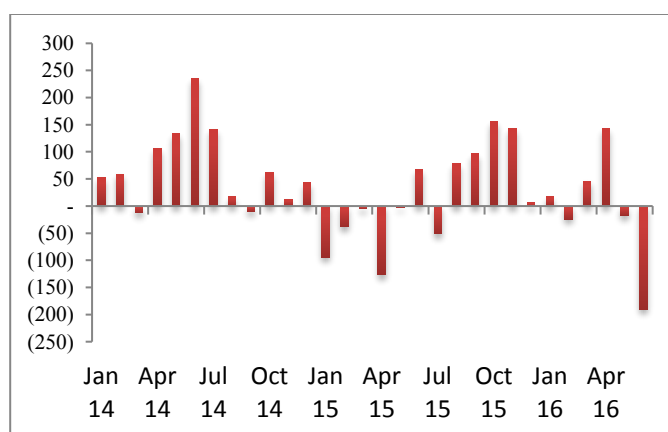
Source: Energy Aspects

⁵ MEES Interview With Saudi Oil Minister Ali Naimi, 22 December 2014.

One could argue that some in the market got it wrong at two critical junctures over the last three years. The first instance was in 2014 when many assumed that Saudi Arabia would balance the market on its own despite clear signals of its unwillingness to cut output unilaterally. The second instance was at the beginning of 2016 when the market thought that regardless of what happened to the oil price, there would be no reaction from Saudi Arabia. But Saudi Arabia did react, signaling to the market that the low oil prices in January this year were ‘irrational’⁶ and by showing willingness to cooperate with other OPEC and non-OPEC producers to freeze production. By signaling a shift from a pure market share strategy towards cooperation, Saudi Arabia did influence market outcomes by shifting market sentiment and squeezing ‘shorts’ out of the market, providing support to the oil price.⁷ This represented a new phase in Saudi oil policy, at least in form, but not so much in terms of actual production. Saudi output stabilised at around 10.3 mb/d for the first few months of 2016. But between April and August this year Saudi output jumped to record levels reaching 10.75 mb/d in July to decline slightly to 10.65 mb/d in September. Despite this surge in Saudi output, oil prices continued to recover with the Brent price reaching \$50 at the end of September.

Increasing output while at the same time signaling willingness to cooperate on an output cut or freeze has, at times, confused the market, with Saudi signals not always appearing clear.⁸ One way to explain the recent increase in Saudi output is in terms of meeting rising domestic demand during summer time. In order to meet the rise in electricity demand, Saudi Arabia increases its burn of crude and other liquids in the power sector during summer. However, there are now enough data points to suggest that crude burn this year has been lower than in previous years due to a number of factors. These include the slower growth of electricity demand due to improved efficiency and higher electricity prices, and the availability of more gas supplies with the commissioning of the Wasit gas plant. Available data also suggests that domestic demand for diesel has declined year-on-year, due to slower economic growth, the cancellation of many big construction projects, and energy price reforms which increased the price of diesel. Therefore, the swing in summer demand can only partially explain the recent rise in output.

Figure 4: Saudi Crude Burn, y/y change, thousand b/d



Source: JODI

Another explanation is related to the ramping up of recently-completed refineries, which has generated an additional source of domestic demand for crude. The data clearly suggests that refinery runs have been on the rise and are currently well above the five-year average. JODI data also shows that petroleum products exports (particularly diesel) have been on the rise, with Saudi Arabia competing in key markets. The key question here is whether the increase in refinery runs has affected crude exports. There is no clear evidence that it has. Since September 2015, Saudi Arabia has

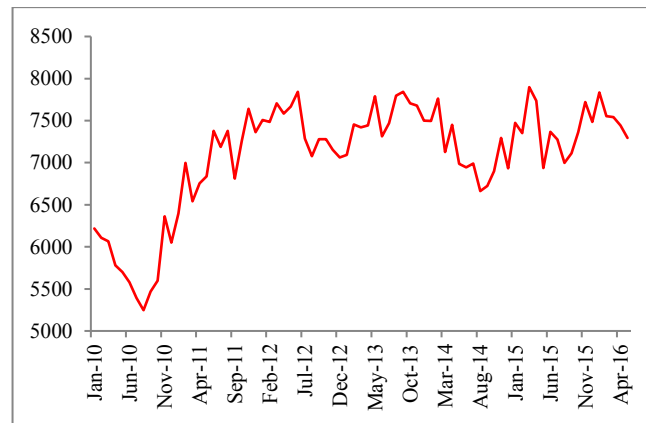
⁶ Financial Times, ‘Saudi Arabia says \$30 oil is ‘irrational’, 21 January 2016.

⁷ J. Kemp, ‘Saudi Arabia squeezes hedge funds with bearish bets on oil’, Reuters, October 10, 2016.

⁸ See B. Fattouh, ‘The Low-Cost OPEC Cycle: The Big Elephant in the Room’, Presented the Bank of England <https://www.oxfordenergy.org/publications/low-cost-opec-cycle-big-elephant-room/>

maintained its export levels above 7.3 mb/d. So in effect, Saudi Arabia seems to be not only targeting production, but also export levels, which reflects a more aggressive market share strategy.

Figure 5: Saudi Oil Exports, thousand b/d



Source: JODI

If domestic demand considerations can't fully explain the recent rise in Saudi output, does this mean that there is a new Saudi oil policy in the making? Again the answer to this question is not unambiguous. One could argue that the recent increase in output is simply a continuation of the market share strategy that was initiated by Ali Al-Naimi in 2014. Alternatively, one could argue that during negotiations with other producers, it is important to keep output elevated, as this will improve Saudi Arabia's bargaining power in the current talks about a potential production freeze or cut. So this could simply be a tactical move.

But, even if there has not been a big adjustment in Saudi oil output (if anything the adjustment has been on the upside), Saudi Arabia's willingness to cooperate with other producers still represents a fundamental shift at least in form. So the key question is: What have been the main drivers behind this shift in Saudi oil policy?

III. The Drivers of the Shift

Saudi Arabia's output policy is not constant and is shaped by many factors: some are internal (such as heavy reliance on oil revenues), some are external (such as the nature of the shock hitting the oil market and the change in market conditions) and some are related to OPEC dynamics (the ability to reach agreement with other OPEC members which often requires that Saudi Arabia takes a leading role if negotiations are to have any chance of success). As these factors evolved over the last two years, so did Saudi Arabia's behavior.

On the domestic front, despite its relatively strong fiscal buffers when compared to other OPEC countries, the Saudi economy has been squeezed by low oil prices. After achieving an annual real growth rate of 3.6% and 3.5% in 2014 and 2015, economic growth is projected to slow down to 1.2% in 2016. Lower government spending and tighter credit have had knock-on effects in the private sector, which still relies heavily on public spending. The growth of the private sector almost stalled while non-oil sector growth turned negative in Q4 2015 and Q1 2016 before recovering slightly in Q2 2016. Sectors such as construction and government services have contracted sharply while the Saudi stock market index has lost almost half its value from its August 2014 peak. In 2015, Saudi Arabia registered a budget deficit of almost 16% of GDP, and the IMF projects the deficit will stay elevated at 13.5% of GDP in 2016. Although imports are projected to fall sharply from \$259 bn in 2014 to \$217 bn in 2016, the current account registered a deficit of \$53.5 bn in 2015 and is projected to fall slightly to \$42.3 bn in 2016.⁹

⁹ IMF Regional Economic Outlook: Middle East and Central Asia, October 2016.

Faced with a ballooning fiscal and current account deficit, the Saudi government has been forced to take a series of painful measures. Back in December 2015, the government increased fuel and electricity prices. Some of these increases have been sharp, though from a very low base, with gasoline prices increasing by around 67% and ethane prices increasing by 133%.¹⁰ The government has also been cutting spending on capital projects. According to media reports, the government has been reviewing the finances of thousands of projects (including transport, housing and healthcare projects) valued at about \$69 billion and may cancel as much as one third of these projects¹¹. The government has also cut public sector wages and salaries with ministers' salaries being cut by 20 percent, and those of consultative Shura Council members by 15%. Allowances for public sector employees have also been capped with overtime bonuses limited to between 25-50 percent of basic salaries.

In addition to adjusting public spending, the government has been running down its foreign reserves and increasing its local and foreign borrowing. After peaking at \$737 bn in August 2014, foreign reserves continued to decline reaching \$554 bn at the end of August 2016.¹² Public debt has reached \$73bn at end-August 2016 almost double the amount at end-2015 and more than six times the end-2014 level of \$11.3 bn, taking the debt to GDP ratio to 11.5%.¹³ Also for the first time, Saudi Arabia has tapped international bond markets raising \$17.5 bn in a new bond issue. Earlier this year, the government also signed a \$10bn loan agreement with a consortium of international banks.¹⁴ Resorting to foreign borrowing has enabled the government to slowdown the pace of foreign reserves' withdrawals and avoid draining liquidity from local credit markets.

While these adjustments have been sharp and somehow expected in a lower price environment, the country is neither in crisis nor in panic mode. The debt to GDP ratio is still relatively low and access to local and foreign debt markets is still open with the latest bond issue showing great appetite from investors. Foreign reserves are still relatively high, the government has many attractive public assets earmarked for sale and has plans to boost revenues by introducing some indirect taxes such as VAT and other fees, charges, and excises.

But low oil prices have forced the government to tighten the economy at a quicker pace than originally planned and there is a clear realisation that the persistence of the low oil price environment will limit the government's options looking forward. For instance, while the government introduced energy price increases, these were from a very low base. Further energy price increases will be highly unpopular, especially if adequate mitigating measures to protect the vulnerable are not put in place. So will further cuts in public wages and other allowances or the devaluation of the currency, which will erode consumers' purchasing power. The slowdown in the private sector and the non-oil economy implies that much needed job opportunities for the young population will be expanding at a slower pace than originally anticipated and the government's plans to rationalize public sector employment will face a setback. The valuation of some of the assets, such as the partial IPO of Saudi Aramco, will also be positively correlated to the oil price. In other words, while low oil prices have been conducive to kick starting reforms, a persistent low oil price environment will make these reforms more difficult politically and socially and could derail Vision 2030 if the private sector and non-oil economy are further squeezed and job creation stalls - or if political and social stability are threatened.

This explains in part Saudi Arabia's shift in strategy by signalling its willingness to cooperate with other producers to lift prices. Higher oil prices, towards the \$60 level, would give the Saudi government some breathing space and the ability to phase in additional tightening measures in a more gradual manner. While there is the risk that a higher oil price environment could slow down the pace of reform, this risk seems to be low, especially since \$60/barrel will not be enough to solve the country's long-term fiscal challenge. Equally important, the leadership in Saudi Arabia has so far

¹⁰ See Fattouh et al (2016), 'Striking the Right Balance? GCC Energy Reforms in a Low Price Environment, OIES Comment, May 2016, <https://www.oxfordenergy.org/wpcms/wp-content/uploads/2016/04/Striking-the-Right-Balance-GCC-Energy-Pricing-Reforms-in-a-Low-Price-Environment.pdf>

¹¹ Bloomberg, 'Saudi Cost-Cutting Drive May Cancel \$20 Billion of Projects', 6 September 2016.

¹² Saudi Arabia Monetary Agency, Monthly Statistical Bulletin.

¹³ MEES, 'Saudi Debt Doubles, Further Rise Planned With Imminent Bond Launch, 14 October 2016, Volume: 59 Issue: 41.

¹⁴ The Financial Times, First Saudi bond sale raises \$17.5bn in emerging market record

shown strong commitment to introducing reforms and the willingness to take risks with the economy in the strong belief that failure to restructure the economy would place the country on an unsustainable path and is therefore not an option.

In addition to these developments on the domestic front, the oil market is already rebalancing and the size of the cut needed to balance the market is much smaller. According to IEA data, the implied stock-build in 2015 stood at 1.7 mb/d. In Q3 2016, the stock-build has fallen to 300,000 b/d. Robust oil demand growth in 2015 and large supply losses outside OPEC in 2016 have both contributed to the rebalancing process. Also it remains unclear how fast non-OPEC supply, especially outside US shale, could rebound, given the deep cuts in investment in the last two years. This gives Saudi Arabia some room for maneuver if the potential cut in its output is not compensated for by gains from other places, as this will accelerate the drawdown of inventories. Equally important, signaling is more effective in more balanced market conditions, as any potential cut can accelerate the withdrawal of inventories, shifting market sentiment in the process.

In short, Saudi Arabia (like any other oil producer) needs a higher oil price and it is believed that through collaboration with other producers, Saudi Arabia can 'steward the market'¹⁵ to achieve a higher price given that the market is already rebalancing. One may question whether such a policy would be successful or not, but the argument that Saudi Arabia is acting irrespective of market conditions and because it lacks understanding of how oil markets functions is naïve.

IV. A Deal at any Cost?

It follows that while Saudi Arabia has shown willingness to cooperate, this does not imply that the fundamentals of Saudi oil policy have necessarily changed nor that the kingdom would accept any deal irrespective of the key principles that have been guiding Saudi oil policy so far. Based on its historical record, it is possible to identify four such fundamental principles, which need to be upheld for the success of the negotiations in the OPEC November meeting:

- Saudi Arabia will not act unilaterally and any agreement should be part of a collective effort within OPEC and with other key non-OPEC producers;
- There is a certain production level that Saudi Arabia is not willing to go below;
- Any potential deal should be politically acceptable to the Saudi leadership;
- Most importantly, the deal should have a real impact on the oil price and result in higher revenues for the kingdom.

On the first fundamental principle, there is no escape from the quota system, which remains the only mechanism to regulate output levels within OPEC. Even if there is an agreement between members on the volume of the cut that is required to support prices, assigning quotas for individual countries has always proven to be difficult and this time is no different. There are those countries like Iran and Iraq, which have ambitious plans to increase their productive capacity and believe that other countries have taken their market share over the years. Bringing these countries back within the quota system will prove to be very challenging. Iraq has recently been the most vocal, stating that the country 'should be producing 9 mb/d if it wasn't for the wars' and that some countries have taken their market share. On this basis, Iraq has demanded exemption from the deal.¹⁶ Outside OPEC, the signals from Russia about cooperating on an output freeze or cut have been conflicting so far. Recent history has shown that Russia did not abide by its output agreements with OPEC.¹⁷ Also new project start-ups in Russia this year will total a mammoth 0.57 mb/d, reducing the incentive for Russia to cut or even freeze output.

¹⁵ The Financial Times, 'Opec should 'steward the market' – Saudi Arabia', 2 June 2016.

¹⁶ Reuters, 'Iraq says should be exempted from OPEC output freeze', October 23, 2016.

¹⁷ J. Henderson & B. Fattouh, 'OPEC and Russia: Uneasy Partners', OIES Comment, February 2016, <https://www.oxfordenergy.org/wpcms/wp-content/uploads/2016/02/Russia-and-OPEC-Uneasy-Partners.pdf>

On the second principle, as argued elsewhere,¹⁸ while the kingdom can still adjust its output in both directions, this has become more costly and its output is likely to fluctuate within a much narrower range than was seen in previous cycles. Talk that Saudi Arabia would implement much deeper cuts to allow for exemptions¹⁹ are not consistent with Saudi Arabia's long-term investment strategy. Saudi Arabia has been increasing its drilling activity and ramping its production – 'calibrating' its energy sector to maintain crude production at a level above 10 million b/d.

On the third principle, there is no escape from Iran being part of the agreement, which in effect means that Iran has to agree to freeze production. Letting Iran 'off the hook', even if there is a clear realization that Iran would not be able to increase output much from its current level in the next few months, is not an option for Saudi Arabia. This will not only make the deal politically unattractive in the current environment of rising geopolitical tensions but would also have the effect of diluting the impact of any potential deal.

On the fourth fundamental principle, any Saudi change in output must have a positive impact on the oil price and revenues, which is the ultimate objective of any shift in policy. Any actions/announcements from other OPEC and non-OPEC members that would have the effect of diluting the impact of the signal on market sentiment would change the cost-benefit calculus for Saudi Arabia. So do demands to cut output from highly amplified numbers²⁰ and/or output increases from Nigeria and Libya, which have recently seen some recovery in their production. The worst possible outcome is for Saudi Arabia to cut output and see the volumes lost being replaced by other OPEC producers, with no impact on the oil price. If US shale output rebounds quickly, as many are currently expecting, this will complicate the cost-benefit calculus.

On each of these counts, the challenges facing Saudi Arabia are immense and the probability that these barriers will be overcome by November remains low. However, there is a realization within OPEC that failure to reach any sort of agreement in November will be very bearish for the oil market with the potential to erase all recent price gains. This would continue to put pressure on OPEC to try to reach some sort of agreement, though such a potential deal may not be as neat as many in the market are expecting and OPEC may just decide to postpone some of the difficult decisions on individual quotas to a later date and agree on a collective cut in the hope that the market will be as forgiving as after the Algiers meeting, which is highly unlikely.

Should there be no clear agreement on cutting output and how to allocate individual quotas, Saudi signaling about cooperation will most likely continue, as it has no interest in talking prices down. But in terms of actual volumes it may be a different story altogether, with the possibility of output being maintained at high levels, or even increased until a collective agreement is reached, delaying the rebalancing process. This is a risk that both producers and the market should not ignore.

¹⁸ See B.Fattouh and A. Sen (2015), 'Saudi Arabia Oil Policy - More than Meets the Eye?', OIES MEP 13, Oxford: Oxford Institute for Energy Studies. <https://www.oxfordenergy.org/wpcms/wp-content/uploads/2015/06/MEP-13.pdf>

¹⁹ Bloomberg, 'Saudi Arabia Faces Tough OPEC Equation With Mounting 'Exemptions'', October 25, 2016.

²⁰ See for instance, R. Mallinson on Iraqi numbers. R Mallinson, 'Can Iraqi oil production surprise again on the upside?', OIES Comment, October 2016. <https://www.oxfordenergy.org/wpcms/wp-content/uploads/2016/10/Can-Iraqi-oil-production-surprise-again-on-the-upside.pdf>