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PROSPECTS FOR OIL PRICES IN 2017

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> **Oil producers have agreed to cut supply**, prompting a jump in the oil price. After years of oversupply and with inventories at record highs, the recent agreement boosted market sentiment. But careful reflection suggests that the deal is unlikely to support higher prices through 2017.

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Since mid-2014, the crude oil market has been struggling with oversupply. This was largely the result of Arab governments' desire for higher prices to buy off potential internal political unrest following the Arab Uprisings that started in 2011. They achieved these higher prices (from 2011 to 2013, Brent crude oil averaged $110.53 per barrel) because Saudi Arabia quietly revived its role as swing producer to balance the market.However, these high prices led to both demand destruction and increased supply. The supply effect was particularly important given the impact of the shale technology revolution in the US, where production increased by 5.2 million barrels per day (b/d) between 2010 and 2015.

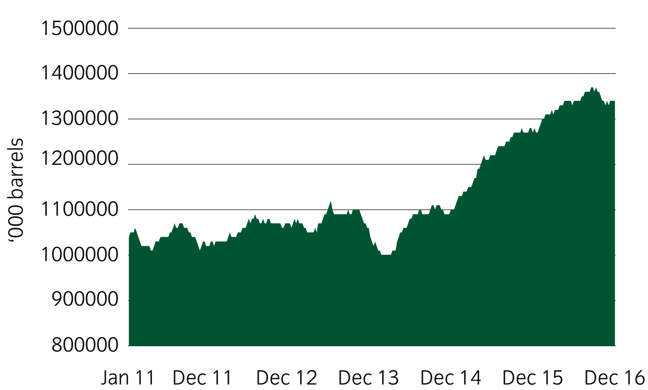
Inevitably, the supply overhang meant inventories reached record levels (see Figure 1). From June 2014, this created downward pressures on crude prices. In November 2014, Saudi Arabia adopted a new strategy aimed at taking market share from the high-cost producers by refusing to cut production to defend price. The Saudis simply wanted the supply curve to go the right way – i.e. low cost producers supplying first, with high cost producers taking the residual market share. The result was a price collapse and Brent fell from $111.80 in June 2014 to $30.70 in January 2016.

Since the start of 2016, Saudi Arabia appears to have backed away from this strategy as the financial consequences began to bite. It has been trying to secure an agreement within Opec and with some key non-Opec producers: initially to freeze production and more recently to cut supply. In September, at the Algiers Opec meeting, a cut was agreed but no details were released. On 30 November, a "deal" was announced. Opec members agreed to cut production by 1.2 million b/d from 1 January 2017 (see Figure 2). Nigeria and Libya were excluded, and Indonesia was "excused". However, the agreement was conditional upon non-Opec countries agreeing to cut by 600,000 b/d. The details of this agreement were expected to be resolved at meetings to be held in Moscow on 9 December and Vienna on 10 December.

The market immediately responded positively with typical irrational exuberance. Commentators hailed the first agreed Opec cut in some eight years, and Brent quickly moved above $54 per barrel. However, the point that an agreement was reached should have come as no surprise. The hype surrounding the build-up to the meeting since the Algiers agreement to cut in September meant that failure to agree on 30 November would have led to a price collapse. Fear of this outcome was sufficient to sideline the real and deep divisions between Riyadh and Tehran that go far beyond oil. Some form of agreement, no matter how anodyne, was essential.

Saudi Arabia has been trying to secure an agreement within Opec and with some key non-Opec producers: initially to freeze production and more recently to cut supply. The deal announced on 30 November led the market to respond positively with irrational exuberance

Figure 1: United States weekly stocks crude and products (excluding the Strategic Petroleum Reserve) 2011-2016



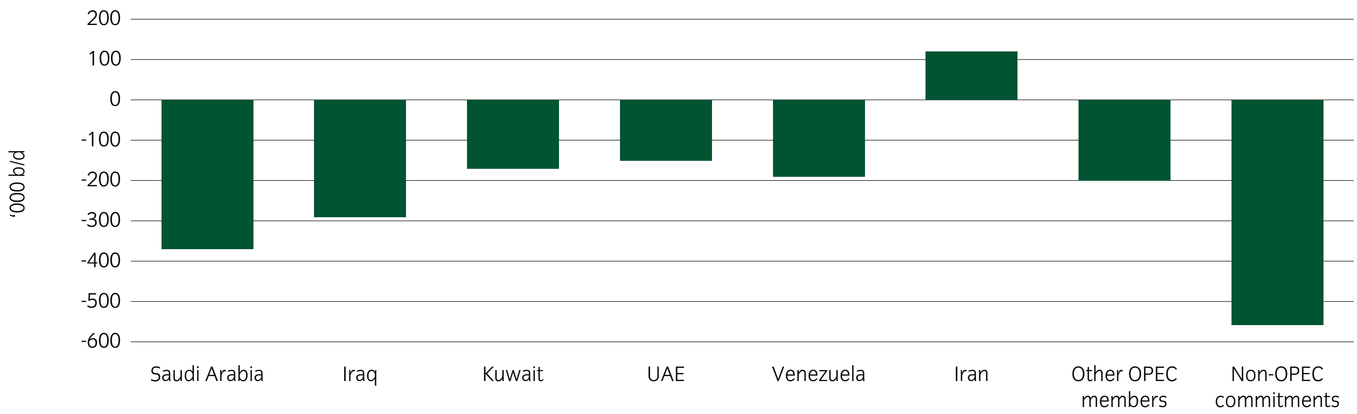
Source: United States Energy Information Administration website.

> **The oversupply that caused the price collapse and the record levels of inventories remain in place. Until that overhang disappears, the market cannot support much higher prices and it appears the markets' initial enthusiasm for the deal is misplaced.**

Careful reflection suggests the deal is unlikely to support higher prices for any period of time through 2017 at least. This is due to several factors:

- **Non-Opec support:** A cut of 600,000 b/d was required from non-Opec oil producing countries if the agreement is to be honoured. At the meetings on 9 and 10 December, 11 non-Opec countries agreed to cut 558,000 b/d. Such an agreement should not have come as a surprise. As with the meeting on 30 November, the market would have severely punished any failure to agree. However it should be remembered that the record of such agreements between Opec and non-Opec has been pretty abysmal. They are rapidly reneged on; the classic examples being May 1998 when Russia, Mexico, Oman and Norway agreed to support an Opec cut. Only Oman delivered. A similar story emerged in 2001. Now Russia is expected to cut by 300,000 b/d. But like many other non-Opec countries that signed up on 10 December, this is from record levels of production that were unlikely to be sustained. Furthermore, according to Alexander Novak, the Russian Minister of Energy, Russia will only be able to reduce production "gradually" because of "technical issues". This could be perceived as a way to ready markets for an underwhelming outcome. It is also worth pointing out that Russia has very publicly stated that good Opec compliance on any agreement is a necessary condition for Russia to deliver on its promised cuts.

Figure 2: Agreed changes to production



Source: OPEC changes Middle East Economic Survey 9 December 2016.

- **Opec's record on quota compliance**: This has been notoriously poor ever since the first quotas were introduced in March 1982. That agreement lasted less than a few weeks. A famous Opec moment came in 1996 when the Venezuelan Minister of Oil, under severe attack in the closed ministerial meeting for "cheating" eventually declared in frustration "we admit we are over-producing, that is not cheating!" To give a flavour of what to expect: before the (failed) Doha meeting in April 2016, which aimed to freeze production based on January levels, both Kuwait and Iraq grossly overstated their January production levels to allow "wriggle room" in the event of a freeze. A key sticking point on 30 November was which figure to use to measure the cuts from – secondary or government sources. The only realistic questions are how soon will the cheating begin, how widespread will it be, and how far will Russia use it as an excuse to renege on its commitments?
- **Supply response:** The shale technology revolution based on horizontal drilling and hydraulic fracturing has dramatically changed the responsiveness of oil supply to price. Conventional oil supply faces lead times of five to 10 years at least. However, for shale/tight oil the lead time is a matter of months. Also, in the US, there are a large number of wells that have been drilled and uncompleted: the so-called "fracklog". Already the higher prices seen since the Algiers accord in September have led to an increase in drilling and fracking activity. US production of liquids (crude and natural gas liquids) has increased by 300,000 b/d since September. Prices much above $50 per barrel will increase supply to quickly choke off further increases.

The oversupply that caused the price collapse and the record levels of inventories remain in place. The precise extent of the market overhang is not clear, simply because oil market data are extremely unreliable. However, it seems that Opec's over-production since summer, triggered by expectations of an Opec cut (Reuters suggested that Opec production rose 370,000 b/d in November alone) means the rebalancing of the market now looks further and further away. It seems likely that the supply overhang will linger long into 2017. Until that overhang disappears, the market cannot support much higher prices and it appears the markets' initial enthusiasm for the deal on the 10 December is misplaced.

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