Production Cuts

FOLLOWING the historic agreement between OPEC and non-OPEC states to curtail production at the end of November and start of December 2016, oil prices appeared to stabilise at a new, higher level. Brent traded in a relatively narrow band of US$53-56 per barrel for most of the period, as the market firmed on early signs of compliance.

Balancing the positive indications from most OPEC states and from some non-OPEC states, stock builds in the US and elsewhere tempered some of this optimism, and spot prices ultimately dipped slightly in early March, with Brent trading closer to US$50.

OPEC

To help improve credibility, OPEC is basing countries' compliance record not on self-reported numbers but on the group's 'secondary sources' figures – which are based on volumes reported by six independent organisations. According to these figures, overall compliance among the 11 participating states (excluding the exempted Libya and Nigeria) reached 95% in January and 109% in February – or 102% overall, for the two months.

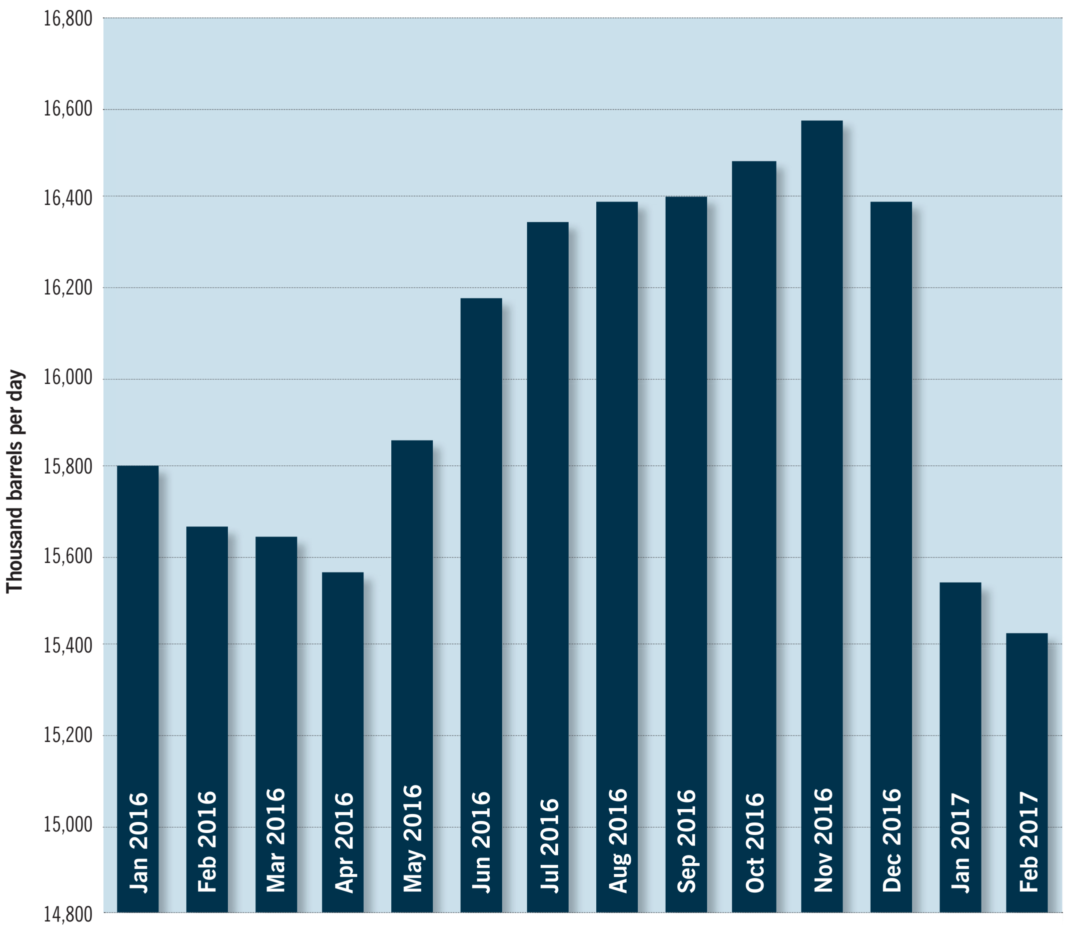
Table 1: OPEC Compliance Record (Source: OPEC, NBR)

	Agreed Production		Jan '17		Feb '17		Jan-Feb '17 Avg	
Member	Reference Level (kbpd)	Target Level (kbpd)	Production (secondary sources) (kbpd)	% Compliance	Production (secondary sources) (kbpd)	% Compliance	Production (secondary sources) (kbpd)	% Compliance
Algeria	1,089	1,039	1,053	72%	1,053	72%	1,053	72%
Angola	1,751	1,673	1,659	118%	1,641	141%	1,650	129%
Ecuador	548	522	531	65%	526	85%	529	75%
Gabon	202	193	201	11%	194	89%	198	48%
Iran	3,975	3,797	3,778	111%	3,814	90%	3,795	101%
Iraq	4,561	4,351	4,476	40%	4,414	70%	4,447	54%
Kuwait	2,838	2,707	2,718	92%	2,709	98%	2,714	95%
Qatar	648	618	623	83%	622	87%	623	85%
Saudi	10,544	10,058	9,865	140%	9,797	154%	9,833	146%
UAE	3,013	2,874	2,962	37%	2,925	63%	2,944	49%
Venezuela	2,067	1,972	2,003	67%	1,987	84%	1,995	75%
Total OPEC-11	**31,236**	**29,804**	**29,869**	**95%**	**29,682**	**109%**	**29,780**	**102%**

Compliance has not been uniform, however. As we had anticipated, Saudi Arabia took the lion's share of the reduction, with output reduced to 9.8 mbpd in February – around 260 kbpd deeper than required. Saudi's GCC allies, Kuwait and Qatar, also broadly met their own commitments, although UAE seemingly did not. UAE officials have said that they intend to back-end cuts, to meet their commitments over the period as a whole, rather than in any particular month – highlighting the shortcoming of the six-month average targets, which reduce accountability as non-compliance cannot ultimately be proved until after the fact.

Nonetheless, overall compliance among the core Swingers has clearly been impressive to date, indicating a commitment to managing the market once again. Following a period of very high and stable production between July and December last year, Saudi, Kuwait and UAE have cut a combined 964 kbpd from their reference production levels. The graph below shows a production behaviour that to us indicates a very clear adherence to a swinging philosophy – underpinned by the centrality of oil prices to government revenues in these countries. The reason for the UAE's apparently sluggish compliance remains unclear, however.

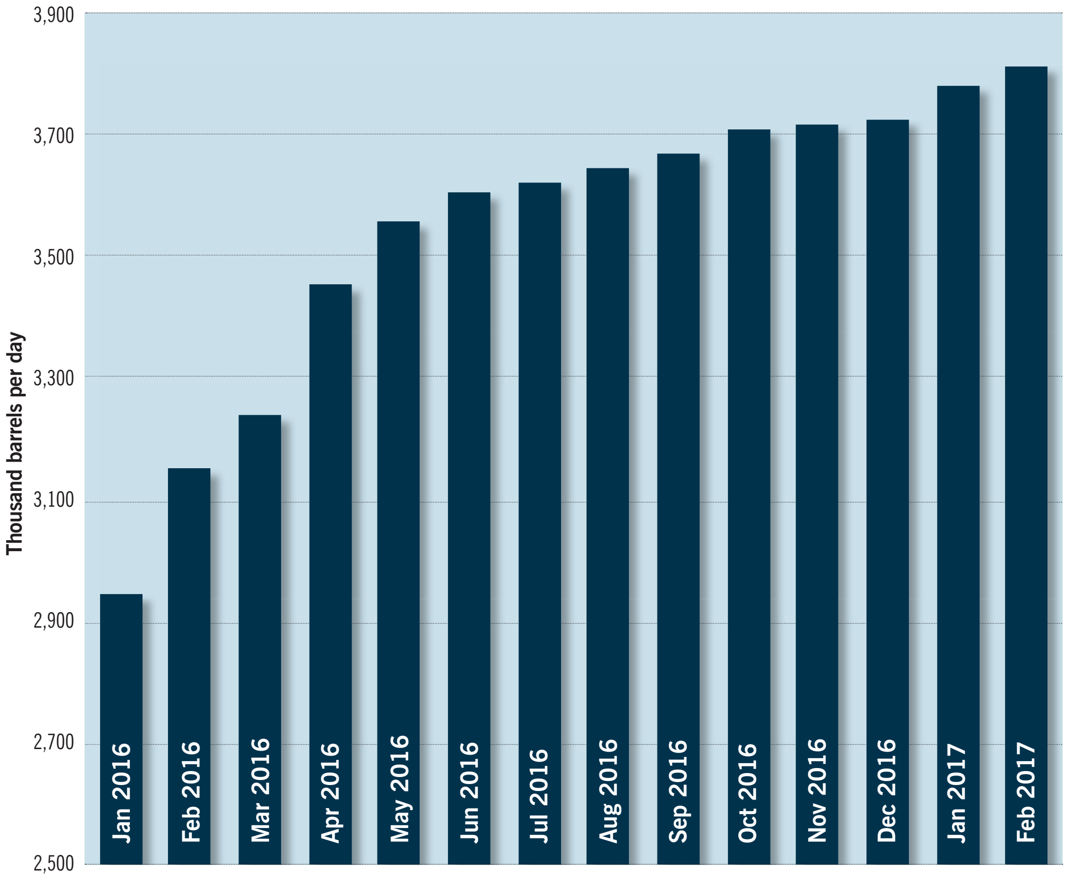
Graph 1: Gulf Swingers Monthly Combined Crude Production



Source: OPEC secondary sources

By comparison, and as we had warned, early indications of compliance from Iran and Iraq, the GCC's regional rivals, seem weak. Iraq seemingly cut production by an average of just 114 kbpd (or 54% of its target) over the first two months of this year versus October, although Baghdad does appear to be moving slowly towards increasing compliance. Iran, which had been allocated an elevated reference production level, allowing it to increase production slightly, has already reached its target level – spooking some market observers.

Graph 2: Iran Crude Production



Source: OPEC secondary sources

OPEC's self-reported production numbers for January and February tended to be higher than those from secondary sources. In some cases, such as Venezuela, this may be playing to a domestic political audience. In others, particularly Saudi, which claimed to have cut 200 kbpd less in February than independent sources suggested, this could be designed to deflect from the fact it seems to be compensating for other countries' compliance shortcomings. Alternatively, it may be part of a more deliberate misinformation strategy, designed to keep uncertainty high and deter investment.

Regardless, the disparity highlights the difficulty in monitoring production levels of OPEC countries, and by implication their real compliance levels – and reinforces the caution with which we treat any direct communication from OPEC states. Following the disclosure of Saudi's February number, the Kingdom was motivated to issue a statement saying additional production had gone into storage, rather than being exported.

Considering its apparent over-compliance to date, it will be interesting to see whether Saudi opts to grow production over the coming months, as the summer approaches. Oil consumption in the country tends to increase in the summer months as Liquids-fuelled power generation comes into action, in order to provide air-conditioned respite for citizens. If Riyadh does not allow production to grow, the increased call on domestic supplies will further restrict exports. Saudi's response to seasonal changes in demand will be useful in gauging compliance within the group and the broader impact on market Equilibrium.

A Joint Ministerial Monitoring Committee (JMMC) is meeting for a second time at the end of March, and will likely deliver an upbeat report on compliance. But we remain sceptical about the stability of the OPEC agreement over its entire term and still expect compliance outside the core Swingers to wane as incentives not to cheat are eroded closer to its planned end.

The OPEC Secretariat will convene next at the group's biannual meeting on 25th May, at which it will reassess OPEC's strategy and decide whether or not to persist with cuts. The market seems, at present, on track to rebalance over the coming months – if it has not already – and continued production abatement would likely lead to a significant Positive Disequilibrium in the second half of 2017, as seasonal demand picks up.

In March, Kuwait became the first OPEC member state to openly support an extension of the agreement beyond June. But other members may have less appetite for an extension – a scenario we highlighted in our Q4 Update. Saudi Energy Minister Khalid Al-Falih has had to navigate a path between reassuring markets, while also warning against a "free ride" for US shale producers, which have been the fastest to respond to the increase in prices.

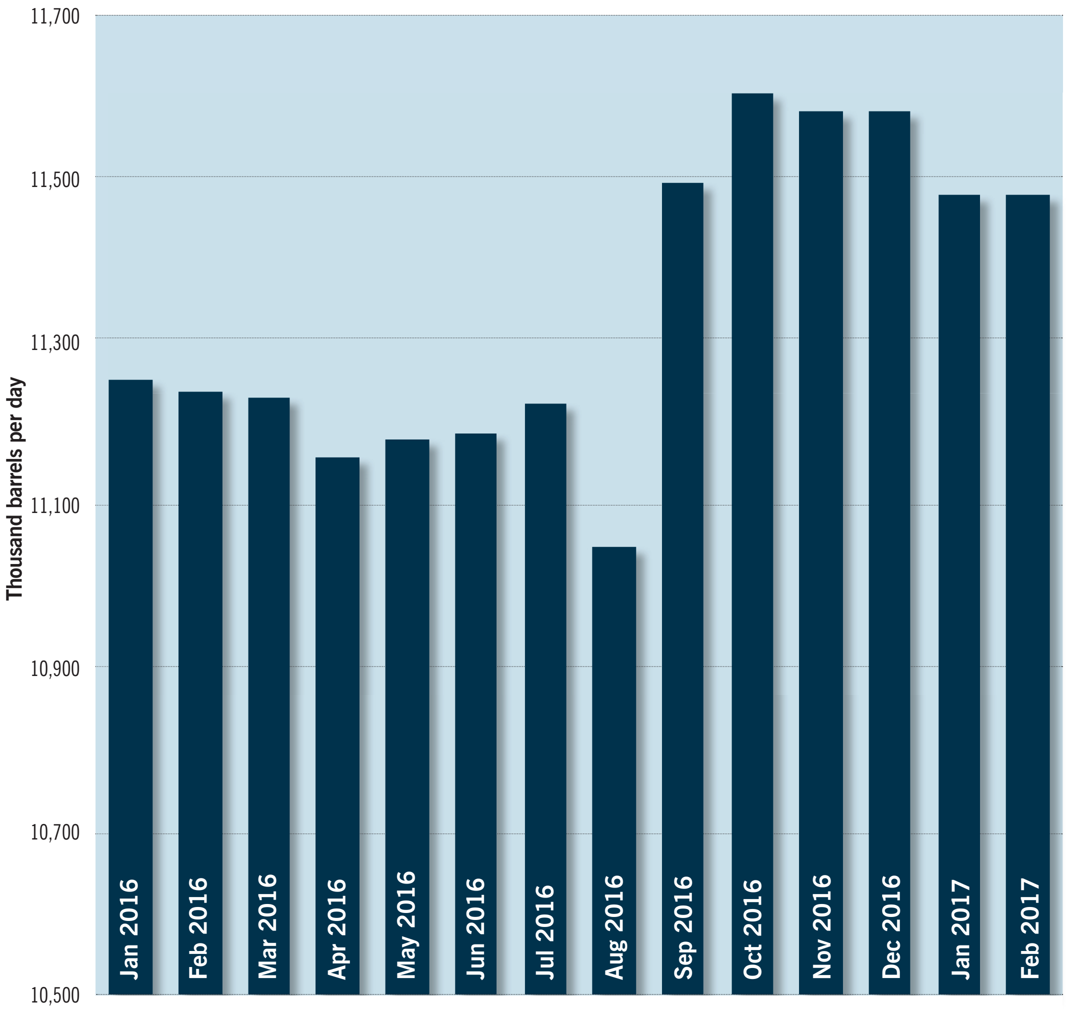
Saudi messaging, including a suggestion that the agreement won't be extended, is entirely consistent with the core thesis of our 2016 Annual Report that Saudi will continue deterring investment into US tight oil by maintaining a high perception of price risk. We had been surprised by the timing of the OPEC agreement in November, with the apparent return of the Swingers coming a year earlier than we had anticipated. Should they allow the production agreement to break down after the initial six months, and opt instead for a temporary return to production maximising, the strategy would fit within the roller-coaster pattern of managed volatility which we had identified last summer as the Swingers' most rational course of action.

Non-OPEC

In addition to the agreed OPEC cut, which amounted to around 1.4 mbpd from reference levels or 1.2 million bpd from actual levels, a disparate group of 11 non-OPEC states committed to reducing production by 600 kbpd. But non-OPEC compliance has been less clear-cut than that within the group.

Half of the agreed 600 kbpd was to come from Russia. Russian production was down by more than 100 kbpd in January on October levels, according to the IEA, at 11.48 mbpd, but remained flat in February. Reports suggest that it is larger companies which have borne the brunt of the cuts, with smaller companies failing to follow through on their commitments.

Graph 3: Russia Total Liquids Production



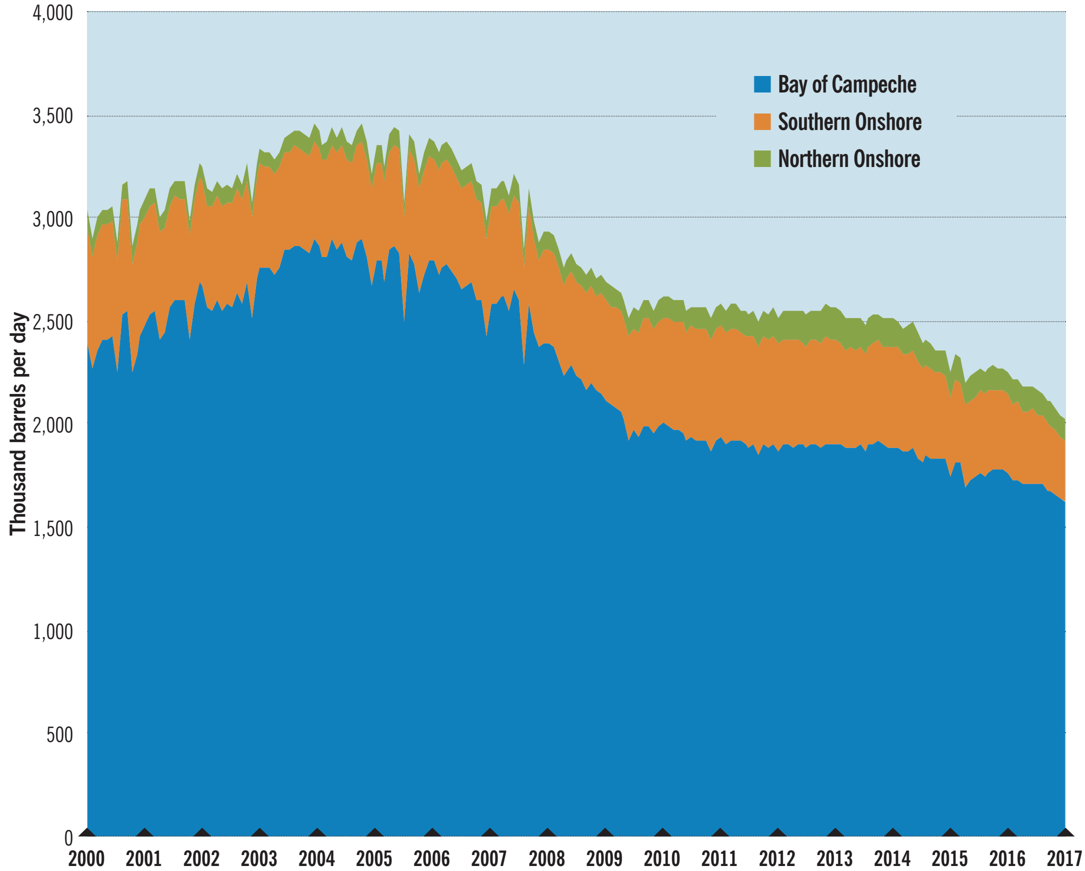
Source: IEA

Some commentators have suggested the failure to further reduce production in February implies a waning commitment to continue cutting – which could trigger a broader unravelling of the potentially fragile agreement. Although the stated Russian target of 300 kbpd by the end of April remains achievable, the observed Russian behaviour to date (an early cut followed by a period of flat production with the promise of further cuts), could be seen as a way of testing the water by signalling intent without following through in any material way. As such, we remain very sceptical about Russian intentions. In the meantime, though, the strong growth seen in the second half of 2016 does at least seem to have been checked.

Information is harder to track on the other 10 non-OPEC producers, since the production cuts required are similar to rounding errors in many cases. Kazakhstan, highlighted in our Q4 Update as a country facing an uphill challenge to cut, has proved predictably reticent to date, with official data showing output instead growing at the start of this year. This is seemingly in large part due to increases from Tengiz and Kashagan. The latter, which finally came (and stayed) online in October, reached 170 kbpd in February – above our forecast from last summer. As the field's initial ramp-up fades, Kazakhstan's growth should slow, and possibly reverse as declines continue elsewhere, before Kashagan resumes growth towards its phase 1 target of 370 kbpd later in the year, or in 2018 – assuming no further disruptions or delays.

The IEA, in mid-March, put the non-OPEC group's overall compliance at around 40% in January, with an expectation that this had been reduced to 34% in February – although with the caveat that data was scarce. Early indications that non-OPEC compliance has been weak other than for countries that are in natural decline, such as Mexico and Azerbaijan, is consistent with our world view, made explicit throughout our analysis, that the majority of countries are, and always will be, production maximisers with little desire or ability to restrict production over anything other than the very short term. ❖

Graph 4: Mexico Crude Production Decline



Source: Sistema de Información Energética (SIE), Gobierno de México