June 18 OPEC Meeting Guide

Introduction

OPEC members will meet in Vienna to discuss production limits on Friday 22nd June. Unlike most meetings since late 2016 when OPEC agreed to production limits in concert with Russia and other non-OPEC members, there is great uncertainty as to the outcome of this meeting. The unusual silence of members who had been content to keep quiet and let their production cuts feed into oil prices as inventories declined, has ended abruptly. Instead we are back to the constant public bickering that characterised the behaviour of members for most of 2015 and 16. There is now a very clear and very public split between members including Saudi Arabia and de facto member Russia who favour production increases and Iran, Venezuela and Iraq, that are opposed.

Spare Capacity

The table below shows that Saudi Arabia has substantial spare capacity, accounting for nearly two thirds of the combined spare capacity of OPEC members. Also, as a percentage of production, Saudi Arabia's idle production is much greater than that of the other large producers in OPEC. Russia does not publish spare capacity figures, but it is estimated that is might be as much as 500k b/d[1] – larger than any OPEC member other than Saudi Arabia. At the other end of the spectrum Venezuela and Iran have both been targeted by US sanctions and its seems will almost inevitably experience declines in output whether they like it or not. Clearly if a producer is unable to share in increased production that would presumably lead to oil prices being lower than they would otherwise have been, they will be penalised by others increasing production. This explains why a production increase is anathema to Iran, Venezuela and Iraq.

Producing Country[1]	Current (m b/d)	Capacity (m b/d)	Spare (m b/d)	Spare (%)
Algeria	1.04	1.08	0.04	3.8%
Angola	1.53	1.58	0.05	3.3%
Ecuador	0.53	0.54	0.01	1.9%
Gabon	0.17	0.21	0.04	23.5%
Equatorial Guinea[2]	0.12	0.13	0.01	8.3%
Iran I.R.	3.82	3.85	NA	NA
Iraq	4.47	4.75	0.28	6.3%
Kuwait	2.71	2.93	0.22	8.1%
Qatar	0.61	0.63	0.02	3.3%
Saudi Arabia	10.02	12.04	2.02	20.2%
UAE	2.87	3.2	0.33	11.5%
Venezuela	1.36	1.46	NA	NA
OPEC12 Sub Total	**29.25**	**32.4**	**3.15**	**10.8%**
Libya	0.97	1.02	0.05	5.2%
Nigeria	1.47	1.7	0.23	15.6%
OPEC Sub Total	**31.69**	**35.12**	**3.43**	**10.8%**

Source: IEA, OPEC, Investec
1. Indonesia suspended its membership in 2016 and has been removed from all figures
2. Equatorial Guinea became a member in 2017.

[1] *Source: Bloomberg: https://www.bloomberg.com/news/articles/2018-06-11/russia-said-to-boost-oil-output-as-commitment-to-opec-cuts-wanes*

What are OPEC and Other Signatories to Cuts Producing?

Compliance with the cuts agreed in 2016 are at an impressive 161% for OPEC members that agreed to cuts and 132% overall when other countries that agreed to cuts are included. This means that there is 0.55m b/d less oil currently being supplied to the market than OPEC had intended. Consequently global inventories have drawn down much more quickly than expected, particularly in view of robust demand and so it is entirely logical that OPEC should be considering raising the limits earlier than the end of this year as the current agreement stipulates.

Producing Country[2]	Oct 16 Production[1] (m b/d)	Cut (m b/d)	Limit (m b/d)	Current (m b/d)	Actual Cut (m b/d)	Actual less Required	Compliance
Algeria	1.089	-0.050	1.039	1.04	-0.049	0.001	98%
Angola	1.751	-0.078	1.673	1.53	-0.221	-0.143	283%
Ecuador	0.548	-0.026	0.522	0.53	-0.018	0.008	69%
Gabon	0.202	+0.009	0.211	0.17	-0.032	-0.041	-356%
Equatorial Guinea[3]	0.140	-0.007	0.133	0.12	-0.020	-0.013	286%
Iran I.R.	3.707	+0.090	3.797	3.82	0.113	0.023	126%
Iraq	4.561	-0.210	4.351	4.47	-0.091	0.119	43%
Kuwait	2.838	-0.131	2.707	2.71	-0.128	0.003	98%
Qatar	0.648	-0.030	0.618	0.61	-0.038	-0.008	127%
Saudi Arabia	10.544	-0.486	10.058	10.02	-0.524	-0.038	108%
UAE	3.013	-0.139	2.874	2.87	-0.143	-0.004	103%
Venezuela	2.067	-0.095	1.972	1.36	-0.707	-0.612	744%
OPEC12 Sub Total	**31.108**	**-1.153**	**29.955**	**29.250**	**-1.858**	**-0.705**	**161%**
Libya	0.528			0.97			
Nigeria	1.628			1.47			
OPEC Sub Total	**33.264**			**31.690**			
Azerbaijan[4]	0.815	-0.035	0.780	0.79	-0.025	0.010	71%
Kazakhstan	1.805	-0.020	1.785	1.971	0.166	0.186	-830%
Mexico[4]	2.400	-0.100	2.300	2.1	-0.300	-0.200	300%
Oman[4]	1.019	-0.045	0.974	0.98	-0.039	0.006	87%
Russia	11.597	-0.300	11.297	11.35	-0.247	0.053	82%
Others[4]	1.224	-0.058	1.166	1.26	0.036	0.094	-62%
Non-OPEC Sub Total	**18.860**	**-0.558**	**18.302**	**18.451**	**-0.409**	**0.149**	**73%**
Grand Total	**52.124**	**-1.711**	**48.257**	**50.141**	**-2.267**	**-0.556**	**132%**

Source: IEA, OPEC, Investec
1. except that September figures were used for Angola
2. Indonesia suspended its membership in 2016 and has been removed from all figures
3. Equatorial Guinea became a member in 2017. In the absence of any other information its limit has been assumed to be 5% below is October 2016 production level as reported by the IEA
4. Figures are IEA estimates for April rather than May

Why is Compliance so High?

The main driver, so far, has been the 700k b/d decline in Venezuelan production. Despite having the world's largest oil reserves, Venezuela has managed to get itself into a most extraordinary mess that has been made worse by the imposition of US sanctions[2]. The oil industry has entered a downward spiral of falling revenues leading to insufficient investment in infrastructure, causing further declines in production and still lower revenues… The New York Times recently highlighted the plight of the oil industry in "Workers Flee and Thieves Loot Venezuela's Reeling Oil Giant "which makes clear just how precarious the remaining 1.36m b/d of Venezuelan production is.

What Does the Market Need?

According to the International Energy Agency's Oil Market Report for the month of May which was published on the 13th of June, the amount OPEC members will need to produce to balance the market in the last quarter of this year will be 32.10m b/d which compares to estimated May production of 31.69m b/d, leaving a deficit of around 400k b/d if OPEC supply the same volumes then as they do now. If OPEC increased production to offset this deficit, spare capacity would fall to around 3m b/d as shown in the table below. However, it looks unlikely that OPEC will be able to continue producing at these levels if the current limits remain in place because of anticipated declines in Venezuelan and Iranian production. Also included below are three scenarios for a 0.5, 1.0 and 1.5m b/d decline in Iranian and Venezuelan combined output relative to current levels. The picture is not much different for the end of 2019 where the IEA sees strong demand growth continuing to offset the majority of non-OPEC supply growth.

	Q4-18	Q4-19
Call on OPEC	32.10	31.80
May 18 Production	31.69	31.69
Deficit	-0.41	-0.11
OPEC Spare Capacity	3.02	3.32

Scenario 1	Q4-18	Q4-19
Iran / Ven. Reduction	-0.50	-0.50
Deficit	-0.91	-0.61
OPEC Spare Capacity	2.52	2.82

Scenario 2	Q4-18	Q4-19
Iran / Ven. Reduction	-1.00	-1.00
Deficit	-1.41	-1.11
OPEC Spare Capacity	2.02	2.32

Scenario 3	Q4-18	Q4-19
Iran / Ven. Reduction	-1.50	-1.50
Deficit	-1.91	-1.61
OPEC Spare Capacity	1.52	1.82

Source: IEA, OPEC, Investec

There is potential for an even more dramatic scenario where Venezuela descends into civil war and its oil production ceases entirely.

[2] *Source: Reuters: https://www.reuters.com/article/us-usa-oas-pence-sanctions/u-s-imposes-fresh-sanctions-on-venezuela-pence-calls-for-more-action-idUSKBN1I81S1*

Where Does this Leave Us? What Might OPEC Decide?

While the outlook for Venezuelan and Iranian production are very unclear, there seems little doubt that further declines are on the cards. This means that an increase in supply from OPEC and others is very likely to be needed in order to avoid a large deficit opening up later this year, that could lead to higher prices than we have seen thus far in 2018.

Flexible Limits
One entirely logical approach would be to introduce a mechanism that enables members to increase output just enough to offset any widening in the supply / demand balance observed in actual data. Much of what Saudi Arabia and the Russians have been saying could be interpreted in that way. Russian energy minister Novak was quoted as saying “We believe we need to balance the market and not allow for surplus. The market is going the other way. It has to be balanced.” His suggestion that 1.5m b/d might be needed has raised eyebrows, but it is conceivable that such an increase in limits might be necessary to balance the markets. The challenge would be to get Iran, Venezuela and Iraq to agree and to convince the market that the mechanism will be sufficiently robust and not be a backdoor to a return to the market share strategy. This will be very difficult to achieve and OPEC does not have a strong track record in communicating its strategy to markets clearly. The market might react negatively to such an announcement, until the system can be shown to work in practice.

Agree to Disagree
Perhaps the most negative outcome for oil markets would be if OPEC is unable to reach an agreement resulting in a vague statement at the press conference that does not say much more than we will do what is right for the market. This would probably be interpreted as suggesting Russia and Saudi Arabia will increase production unilaterally. The system of limits would be become meaningless. This would be a serious blow to the market.

Stick to the plan
OPEC might agree to maintain its commitment to existing country-by-country production limits. It seems likely, for the reasons given above, that such a move would lead to large market deficit and higher prices by the time of the second and final OPEC meeting of 2018, to be held at the end of this year. Such an outcome would be very bullish for oil prices.