Emirates NBD

OPEC output update

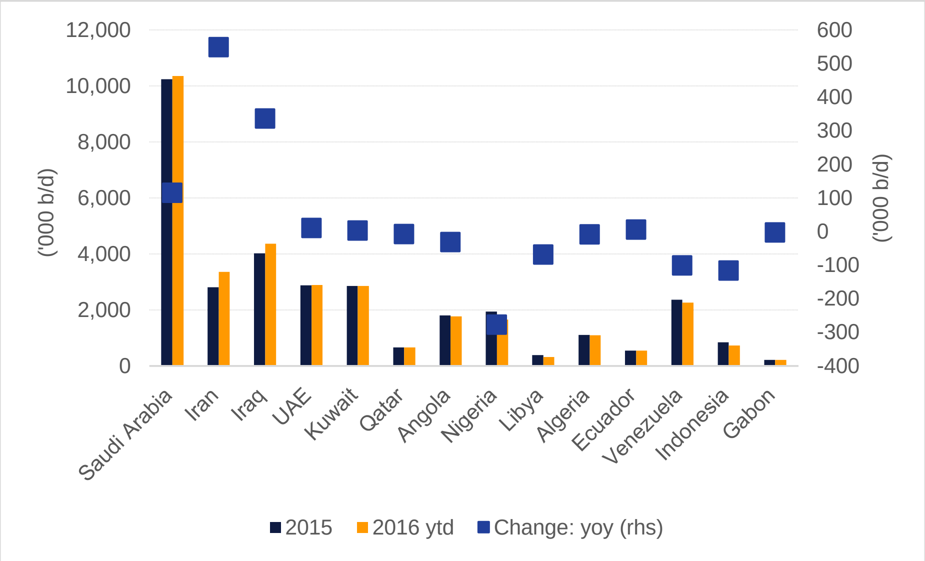
Commodities
6 September 2016

Oil markets have gone nearly full circle in the third quarter, moving into a bear market to the end of July and then rising sharply by mid-August and now showing just how jittery the market is. The main catalyst behind these wide moves has been market speculation over whether and when OPEC would take some form of market rationalization, most likely in the form of a production freeze. Previous attempts to broker a deal to freeze output growth in February and April came to naught and this time too we are doubtful it will be achieved nor will it provide the long-term boost to oil markets OPEC members sorely need.

Have conditions in oil markets changed enough to suggest freezing output would be beneficial? The general trend of markets rebalancing has remained intact over the course of 2016. Crude oil production in the US has fallen by over 450k b/d so far this year up to the end of August while data from Canada, China, Brazil and Mexico all point to lower output this year. There are also tentative signs that inventories in Europe and Asia are being drawn down, albeit they still aren't anywhere close to being described as tight. These improving conditions—and the fact that oil prices have held in a range between USD 45-50/b since mid-April—would suggest that the time is right for OPEC's lower cost producers to actually capture more market share, rather than less.

And indeed this has been the case. Crude oil production from OPEC hit a new record level in August according to latest market estimates. Total output hit 33.69m b/d, up 120k b/d month-on-month and more than 670k b/d on the same month last year. Production increases were concentrated in the Middle East where output from the GCC members rose 140k b/d while Iran and Iraq increased production by 130k b/d. Nigeria recorded another sizeable decrease in output (130k b/d) while Venezuela's production continues to limp along.

OPEC production already at record levels



Source: Bloomberg, Emirates NBD Research.

OPEC's production has increased by 464k b/d as of the end of August compared with average 2015 output, nearly matching the decline in US volumes. The main catalyst behind this increase has been the return of Iran to oil markets after sanctions were lifted in January but Iraq and Saudi Arabia have also made sizeable contributions (336k b/d and 115k b/d respectively). Elsewhere changes in production have been more mixed and output has fallen most extensively in Nigeria and Venezuela (277k b/d and 100kb/d respectively) among the major producers.

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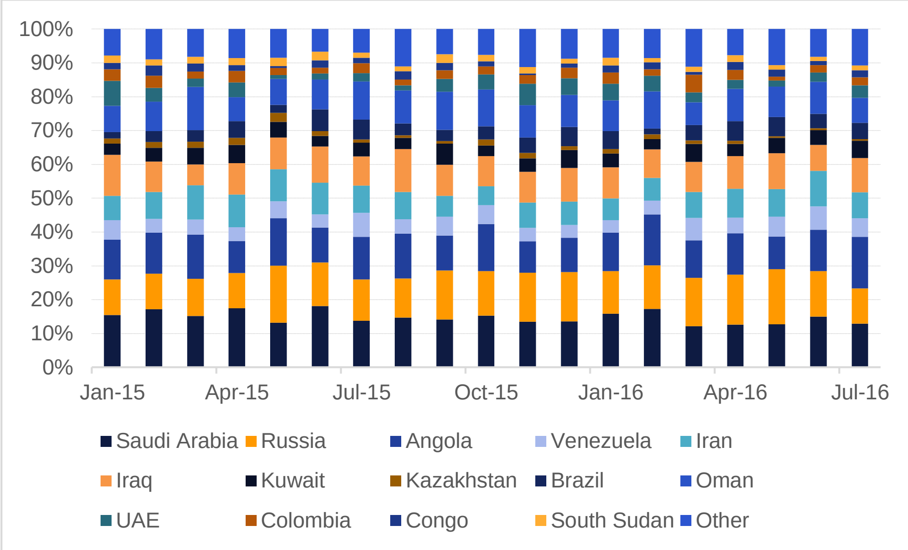
Russia has been stealing a march on OPEC's markets

But while OPEC's big producers have been increasing output, so too has one of their major competitors: Russia. Output there has pushed higher in 2016 (up 133k b/d to the end of August on 2015 average levels) and is at elevated levels (10.8m b/d on average in 2016) relative to historic performance. Russia has also been aggressively pushing oil into China taking an average of 13.5% of the country's total imports from January to July, compared with 12.7% last year. Meanwhile, Saudi Arabia's share has dipped from more than 15% to just over 14% and OPEC's share more generally has fallen. Russia has also been cementing its position as the dominant exporter of crude to the EU while Saudi Arabian exports to the bloc have dipped according to the most recent data from Eurostat.

Fighting for control of China's oil imports



Source: Bloomberg, Emirates NBD Research.

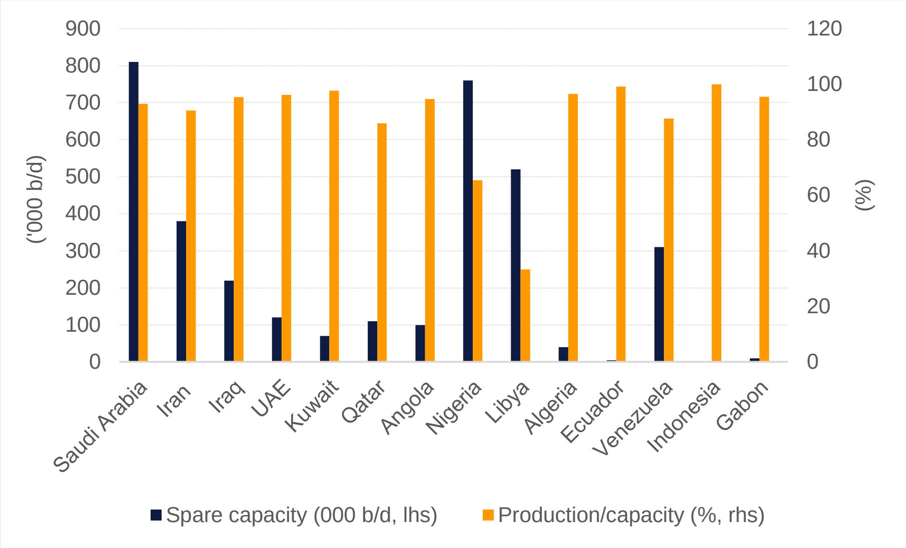
Russia then is the producer for OPEC to do a deal with. For all of the market's attention on US shale, US crude oil exports remain negligible. Since a ban on US crude exports was lifted at the end of 2015 they have risen but are not nearly at a level to concern OPEC producers, just 480k b/d on average this year compared with over 5m b/d from Russia.

Hence the enormous frenzy surrounding a joint statement from the energy ministers of Saudi Arabia and Russia on the sidelines of the G20 meeting in China. Whatever the announcement was, it wasn't an agreement to freeze production. Both countries agreed to cooperate to support global oil markets but fell short of announcing any concrete action. Indeed, nearly immediately after the statement Saudi Arabia's energy minister Khalid al Falih said no freeze was needed at present. To us, this puts paid to any possibility that a deal will be achieved at the upcoming OPEC meeting.

When is a freeze not a freeze?

But even beyond Mr Falih's comments, how could a freeze work in practice? The only positive outcome of an OPEC meeting in the past few years has been the appointment of a new secretary general and most meetings have been fractious rather than friendly. A major obstacle to a freeze deal is what place Iran holds in OPEC. The country's deputy petroleum minister said the country would be prepared to freeze output once it had hit its pre-sanctions share of oil markets. If Iran held to this policy then it would need output to rise by more than 400k b/d to over 4m b/d to capture the around 12% share of OPEC production it had prior to sanctions being removed.

Some in OPEC do have room to expand



Source: Bloomberg, Emirates NBD Research.

Likewise, Nigeria and Libya are producing far below their capacity or historic share of total OPEC output and we doubt they would be prepared to accept a freeze at their currently depressed levels. One possible formulation of a freeze, then, would be to carve out growth allowances for countries where production has dipped for reasons not related to policy. This would mean an increase of 1.7m b/d to OPEC's currently elevated levels if Iran, Nigeria and Libya were given permits to raise output, taking OPEC production above 35m b/d for the first time. Iraq's ambitions would also need to be contained as the country is now reversing policy and encouraging oil companies to raise output to bring in as much revenue to the government as possible.

Freezing at record levels when demand growth is set to slow

Where would all this extra oil be needed? The three major oil market institutions—the IEA, OPEC and the US government's EIA—all project oil consumption growth will slow in 2017 with what demand growth there is to be concentrated in emerging markets. India's demand prospects remain good but even with the fastest expected demand growth in the world, India will need less than 300k b/d to accommodate its marginal demand next year. China's projected demand growth appears too sanguine for us at present: demand for diesel—still the dominant component of Chinese oil demand—has been languishing as government efforts to curb excess industrial capacity and clean up the country's energy mix away from coal are having an impact. Demand growth from the Middle East is particularly uncertain if consumers are exposed to rising prices now that subsidy reform has gather pace across the region. Already this year we are seeing a major slowdown in oil consumption, particularly among oil producers.

Finally, discussion of a market supporting freeze would threaten to undo the hard work of putting a dent into production from higher-cost producers. As oil prices have bounced off lows at the start of the year thanks to verbal market intervention from OPEC, so too has drilling activity and producer hedging in the US. The EIA is already projecting US output will decline at a slower pace next year based on a WTI price forecast of USD 51.58/b, below consensus expectations.

The interest in upcoming OPEC meetings will keep oil markets choppy, particularly as discussion of a freeze will continually get floated. But ultimately we think a freeze remains a point of discussion rather than an effective and easily accepted market strategy.

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