Oil's Well?

By Shafquat Ali, Dubai

© Alamy

Even though the deal was two years in the making, the landmark pact to cut oil production by both the Organization of Petroleum Exporting Countries (OPEC) and non-OPEC member countries on November 30, 2016, came as a surprise or, as US oil producers remarked, a Christmas gift. "We considered all aspects and we came to the understanding that the market needs to be rebalanced," Qatari Energy Minister and OPEC president Mohammed Bin Saleh Al-Sada told reporters in Vienna after an agreement was reached by OPEC members to reduce their collective output by 1.2 million barrels per day to a ceiling of 32.5 million barrels a day, while non-OPEC producers decided to reduce output by a further 0.6 million barrels per day. "Rebalance in the market would need courageous decisions from OPEC and the support of some key countries of non-OPEC," Al-Sada added.

Not surprisingly, the first global oil pact since 2001 between OPEC and non-OPEC producers to jointly curtail oil production had the desired effect as oil prices soared, setting the mood for New Year celebrations. Analysts and financial experts were quick to set a floor under the energy sector and predicted even higher prices for oil stocks in 2017.

However, once the world at large had embraced 2017 and the initial euphoria subsided, the underlying message behind the coming together of OPEC and non-OPEC countries to save their slowing, oil-reliant economies became clear, i.e., hydrocarbons cannot be sustainable economic and energy drivers for the future. Now, as demand grows and oil prices begin climbing upwards, the bigger question is: is it the beginning of good times or are there more hurdles ahead?

Welcome relief

"The agreement among OPEC and some non-OPEC members to limit oil ▶

© Reuters

production not only provides welcome relief to them but also a sense of stability to the international oil market," Masood Ahmed, president of the Center for Global Development, a think-tank based in Washington DC, and former director of the IMF's Middle East and Central Asia Department, told *TRENDS*. "The key to ensuring its sustained impact on production and prices will, of course, be how effectively it is implemented. And for the medium term, the potential for increased production from non-conventional sources will serve to keep upward price movements in check. In this context, the efforts by many oil-exporting countries to curtail public spending, increase non-oil revenues and accelerate the diversification of their economies beyond the oil sector remain both welcome and necessary."

"OPEC's accord with itself and several non-OPEC producers to agree to cut production beginning in January heralds the potential for higher prices," Bjoern Ewers, partner and managing director at The Boston Consulting Group Middle East, told *TRENDS*. He added: "Should the 1.8 million barrels per day (MMb/d) of agreed cuts take place, prices will continue to rally as the forward curve inverts, drawing barrels out of the accumulated stockpiles around the world. It is more likely that only a portion of the cuts will occur – with compliance likely strongest in the first quarter before weakening as countries seek to maximize their revenues from the higher prices – but at the cost and effectiveness of the agreement. However, even half of the planned cuts will cause a significant change from previously growing OPEC production."

"One element that has already been roused by higher oil prices are US shale producers, with rig counts rising for much of 2016," Ewers explained. "The magnitude of higher shale production remains a question – and will be directly impacted by the underlying price. Any growth will offset the OPEC/non-OPEC cuts in equal measure, but will also prove worrisome if demand slows after delivering above expectations since early 2015."

"Recent developments could arguably lead to more stable times, but not to the heady days of 2012, when oil prices hit more than $125 per barrel for Brent and

almost $110 per barrel for West Texas Intermediate," Al Emid, financial expert on Middle East affairs and author based in Toronto, told *TRENDS*.

Impact of production cut

"The deal reached by OPEC to cut oil production has resulted in a significant jump in oil prices," Aasim Husain, deputy director of the IMF's Middle East and Central Asia Department, told *TRENDS*. "The production cuts will help reduce excess supply in the oil market, but the path of oil prices going forward will also be determined by the growth in the demand for oil as well as supply developments elsewhere, including the response of US shale production to higher prices."

"If the oil price increase of recent weeks – which was clearly driven by news about prospects for the deal and its subsequent announcement – is sustained, it should result in higher oil revenues for oil exporters, despite the cuts in production they are making," Husain continued. "This will boost their export and government fiscal revenues. Nevertheless, most oil-exporting countries will still need to continue their deficit reduction efforts and accelerate structural reforms to diversify their economies because oil prices are not expected to recover mid-2014 levels."

"The biggest problem faced by several OPEC nations will not be the demand for their crude oil, but rather their own addiction to high prices," added Afshin Molavi, senior fellow, Foreign Policy Institute of the Johns Hopkins University School of Advanced International Studies. "Many OPEC members will need to cut budgets and trim subsidies. Their market for crude oil is assured, but this does not give them license to spend irresponsibly," he told *TRENDS*.

"The New Oil Normal with lower oil prices and structural change in the oil market led to massive budget and current account deficits for oil producers," Dr Nasser Saidi, president, Nasser Saidi & Associates, explained. He added: "The majority are highly dependent on oil as the main source of government revenue and exports. While the GCC countries have substantial fiscal buffers and foreign exchange reserves, the deficits were not sustainable."

"The GCC countries have responded by undertaking long delayed economic reforms including government expenditure rationalization, the scaling back of subsidies and other wasteful expenditure as well as the planned introduction of taxation," he further told *TRENDS*. "But with the recent OPEC export cuts and subsequent rise in oil prices, the question is whether the policy reforms will be maintained. While the temptation will be to delay the implementation of reforms, the strategy and policies are grounded in the imperative of greater economic diversification, including production, revenue and export diversification."

"Policy reforms are likely to proceed as planned in order to have greater private sector participation and job creation," Saidi continued. "Saudi Arabia's plan to partially privatize Aramco and other state-owned assets is likely to proceed accompanied by corporate governance reforms, including greater transparency and disclosure."

Future of hydrocarbons

"The era of oil has been projected to be dead or dying so many times it is hard to keep track," Alex Vatanka, Senior Fellow, Middle East Institute, The Jamestown Foundation, told *TRENDS*. "When Jimmy Carter first put solar panels on the ▶

top of the White House, many folks said the age of oil is over. Fast forward some 40 years later and now we are speaking of the US itself as the biggest comeback among hydrocarbon producers. Indeed, it is not the policy makers who have been the trailblazers in shaping our relationship with hydrocarbons. That role has been in the hands of technological innovators. That said, and while renewable energy is the big thing to have hit us in the past decade or so, the world's thirst for hydrocarbons is still strong."

"It appears that in the foreseeable future renewables and hydrocarbons can coexist," he continued. "There is enough demand for both energy sources to remain viable. For the OPEC states of the Middle East, the question is how to remain competitive in terms of price and in terms of the ability to attract foreign investors. New technologies mean that new producers are continuously emerging and that can have a real impact on the market share – and financial bottom line – of traditional heavyweight energy producers."

"Every year, we hear the same story: fossil fuels are dying, to be replaced by alternative energy and, every year, that narrative is undermined by the facts and projections," Molavi said. "The fact is that fossil fuels still dominate our global energy picture today, and will continue to do so over the next several decades. We also regularly hear stories about the demise or the end of OPEC. Once again, the facts are stubborn. Some 80 percent of proven crude oil reserves are found in OPEC nations. As the projections for fossil fuel note sustained demand, OPEC will remain at the center of the crude oil universe, and a major player on pricing. While Saudi Arabia remains the OPEC heavyweight and will continue to be so over the next decade, the institution remains relevant and its demise has been greatly exaggerated."

Way forward

"The next few years will be shaped by the relationship between US shale and OPEC, Russia and other key oil producers," Paul Hickin, oil editorial director, S&P Global Platts, told *TRENDS*. "This landmark agreement between OPEC and non-OPEC is providing a floor to oil prices and US shale is providing the

ceiling. Compliance to the deal until the stock overhang disappears, most likely by the third quarter of 2017, according to Platts' estimates, will be pivotal to ensuring the price floor holds, while the speed of return of US shale will determine how low the ceiling becomes. If 2016 marked the battle between shale and OPEC, 2017 is likely to shape how these two entities coexist. While history teaches us to be skeptical about compliance agreements, there appears to be strong signals that OPEC/non-OPEC may just pull it off long enough to get the global oil market back on track quickly and find a new competitive equilibrium."

"There are more fundamental forces and trend factors at work," Saidi noted. "Disruptive innovation is making renewable energy sources increasingly competitive to fossil fuels. The levelized cost of solar and onshore wind electric power is now cost competitive with oil, gas and coal in many countries. The year 2016 will be recorded as the renewable energy turning point: multiple records were broken – the latest in the UAE – with deals to generate electricity from sunshine for less than three cents a kilowatt-hour, half the average global cost of coal power."

He added: "Given the economics of renewable energy and technological advances in energy storage, renewable investments will become a driver of economic growth and development and job creation (with solar photovoltaic alone creating 2.8 million jobs of a total of 8.1 million globally) across a broad spectrum of activities, from infrastructure and logistics to housing, construction and transportation, to agriculture and manufacturing. For the Gulf countries that are blessed with high levels of solar irradiance, this is a historic moment of opportunity to decarbonize and bet on a solar future."

"The world continues changing," explained Al Emid. "Americans adjusted their driving habits in order to reduce fuel consumption and the US is edging towards oil self-sufficiency. China is headed towards at least a partial industrial slowdown, potentially reducing its oil consumption. Iraq could plead for flexibility in its allotment, depending on the number of oil facilities that survive the aerial bombings. And while they may not have the plentiful reserves of OPEC countries, oil exporters such as Canada, Egypt, Trinidad and Tobago, and Tunisia are not members of OPEC or of the group of non-OPEC countries that agreed to participate in the agreement. Kazakhstan, a non-OPEC member, agreed to participate, but has long planned to boost production this year."

"A random factor is whether rising prices will incite some exporters to break ranks," he continued. "These and other pluses and minuses could lead to stable times, but anyone betting on a return to anything close to the glory days of 2012 should keep those bets very small."

While this bigger-than-expected production cut has pushed oil prices up, it remains to be seen whether the momentum can be sustained in the long run. Saudi Arabia, the group's largest producer, which is making the biggest cut at 486,000 barrels, for one, is expecting its oil revenues to increase even with a steep production cut.

This resolve to make money while saving their oil for future use should be reason enough for several of the OPEC nations that do not get along to stick together and allow cash flow to trump geopolitical differences. ■