OPEC – 12 months on, market share strategy continues

At the end of November 2014, OPEC surprised many with a decision to abandon a strategy focused on price and instead pursue a market-share strategy. OPEC met again in Vienna on Friday December 4 and effectively rolled over their current strategy to their next meeting.

We provide comments here surrounding the outcome from the most recent meeting.

OPEC met on Friday (December 4 2015), with concluding remarks that were somewhat ambiguous but implied their production quota would remain unchanged, and that the group was content to keep production at the current elevated levels. The meeting confirmed Indonesia's re-entry to OPEC, having left the group in 2008, but nothing was said explicitly about Indonesia's quota. In their concluding remarks, OPEC made the following statement:

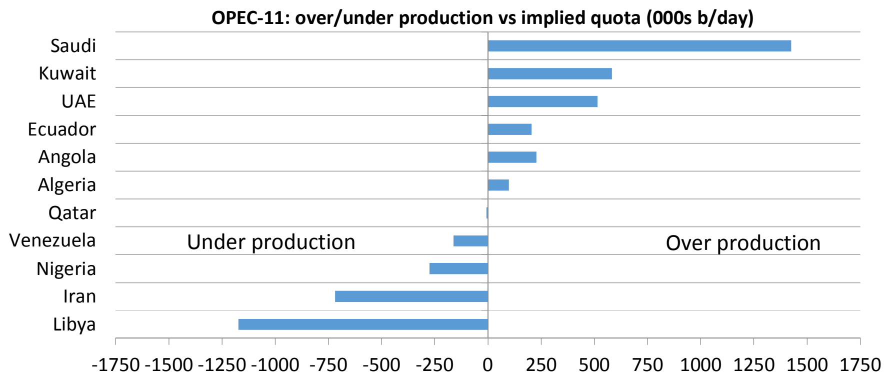
"Having reviewed the oil market outlook for 2015, and the projections for 2016, the Conference observed that global economic growth is currently at 3.1% in 2015 and is forecast to expand by 3.4% next year. In terms of supply and demand, it was noted that non-OPEC supply is expected to contract in 2016, while global demand is anticipated to expand again by 1.3m b/d.

In view of the aforementioned, and emphasizing its commitment to ensuring a long-term stable and balanced oil market for both producers and consumers, the Conference agreed that Member Countries should continue to closely monitor developments in the coming months."

We view the outcome of today's meeting as an endorsement of the stance that Saudi have taken since November 2014, being a desire to see an oversupplied oil market rebalanced via lower non-OPEC production (particularly in the US), assisted by demand growth, rather than by OPEC restraint.

It is clear that divisions exist within OPEC over the market-share strategy, principally between those Middle-Eastern members with deep enough pockets to see the strategy through, and those who are short of funds today. Venezuelan President Nicolas Maduro had reiterated his hopes for a cut just three days before the meeting, making it clear that Venezuela had been pushing other members for a 5% output cut across the group. "The hour has come to put the oil market in order", Maduro said.

As we have pointed out for some time, coherent decision making within OPEC is complicated by the current production picture, and the amount of over/under production versus each country's implied quota. Latest figures for November 2015 are shown below:



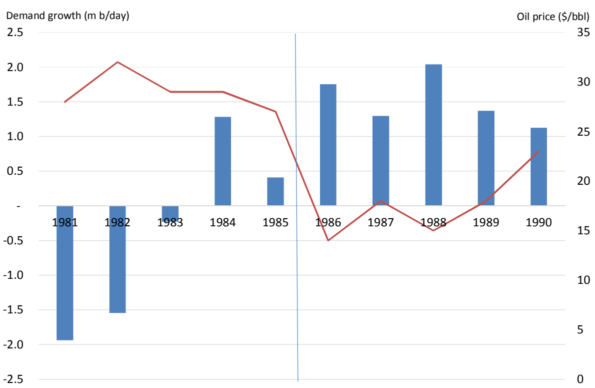
Source: IEA; Guinness estimates (November 2015)

Saudi, Kuwait and UAE are over-producing versus their implied quota by around 2.5m b/day, whilst Iran and Libya, but also Nigeria and Venezuela, are under-producing. Unified action by OPEC has been made difficult by this position, with the under-producing nations reluctant to contribute. And in particular, we sense that Iran were unwilling in the December 4 meeting to commit to much, preferring to reserve their right to restore supply if sanctions are finally lifted in 2016.

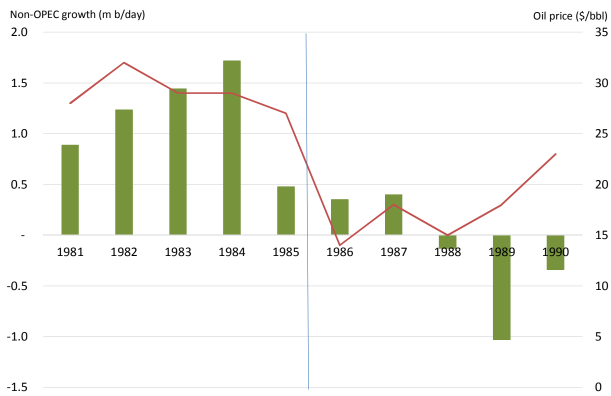
All of that said, nothing in the market has changed our view that OPEC have the ability to put a floor under the price – as they did in 2008, 2006, 2001 and 1998 – *should they choose*.

We highlight that Saudi went through a similar experience in the first half of the 1980s, trying to maintain price at the expense of volume as non-OPEC supply grew, causing them to reduce their production from 9.6m b/day in 1979 to 3.4m b/day in 1985. Eventually the strategy failed and Saudi shifted to an alternative plan of boosting supply and allowing oil prices to fall, slowing non-OPEC supply growth and invigorating demand. This time Saudi are short-cutting the problem, acting sooner rather than later to choke off non-OPEC supply. In doing this, we believe the Saudis have the following picture of non-OPEC supply and global demand in their minds:

<u>Global oil demand and oil price (1981-1990)</u>



<u>Non-OPEC oil supply and oil price (1981-1990)</u>



In particular, from Saudi's point of view, they saw non-OPEC supply fall significantly, with average production growth in the first half of the decade of 1.2m b/day giving way to average decline of 0.2m b/day for the second half. This is what they are on the way to recreating in this oil cycle.

Overall, we reiterate two important criteria for Saudi:

1. Saudi is interested in the average price of oil that they get, they have a longer investment horizon than most other market participants
2. Saudi wants to maintain a balance between global oil supply and demand to maintain a price that is acceptable to both producers and consumers

Saudi's decision not to shoulder an OPEC production cut for the timebeing remains consistent with both of those objectives. We continue to believe that Saudi seek a 'good' oil price, well in excess of current levels, but realise that patience is required to achieve that goal.

As in the mid 1980s, it is a positive demand response and falling non-OPEC production, both well underway, that are at the heart of the rebalancing of this market.

The Guinness Global Energy team
7th December 2015

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