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Opec output freeze won't solve all issues

There are many other factors over which the production group's writ does not run at all

By Samuel Merlin | *Special to Gulf News*

Opec is struggling to enforce one of its founding principles, maintaining stability of price and demand of petroleum. This principle came into full force post market volatility in the 1970s and now is facing a similar test due to the emergence of unconventional oil and gas.

This rapid growth in shale production led to an oversupply in the market which drove down oil prices. Unpredicted global outages from Libya and Nigeria to Canada have further exacerbated this issue, creating an extended period of volatility in oil price ... and a challenging time for Opec.

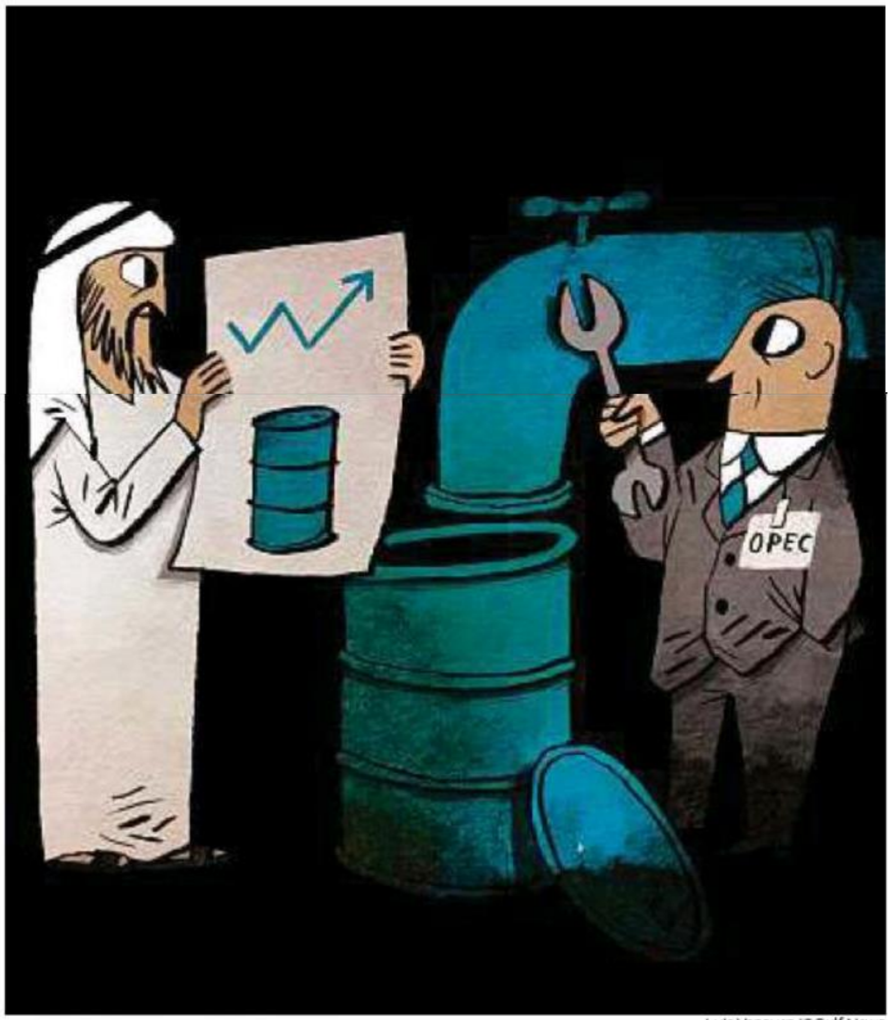
Opec's solution was obvious: a production cut. Doing so would let supply and demand reach an equilibrium and stabilise oil prices to a higher and more sustainable level. But that deal remained elusive until this past week — or did it?

What has been reported is that Opec members in Algiers agreed to a production cut, but what actually has been contemplated is a production freeze. These are two fundamentally different policies which when examined more closely reveal the infighting among Opec's largest producers.

First, the deal at hand. Opec announced the framework of a deal, including:

- A production target of 32.5 million to 33.0 million barrels per day (bpd); and
- The establishment of a committee to recommend production levels of Opec members and consult with non-Opec oil producers.

This past August, Opec was producing 33.25 million bpd, implying it would have to cut 250,000 to 750,000 bpd to fall within this designated range. Pre-summer Opec production (factoring in around 200,000 bpd from Gabon's re-entry) was approximately 32.5 million bpd.



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John Kemp from Reuters noted Saudi Arabia and many Opec members pump more oil during the summer months to meet increased domestic demand for power generation. In Saudi's case, they consistently increase summer production by 400,000 bpd. Expecting those barrels will come offline in the fall, that loss alone will bring total Opec production within the range designated in Algiers. Thus, a production freeze and not a production cut.

Now, achieving the unachievable production cuts.

Opec has historically set production quotas for member-states, but while Opec has carrots, it simply lacks the sticks to enforce members to follow them. As oil prices fell and the "lower for longer" mantra manifested, most Opec member-states filled that revenue gap by pumping more oil — a double-edged sword which solved one problem and exacerbated another.

Further, Opec producers faced unexpected production outages. Nigeria fell to a low of 1.27 million bpd from over 2 million due to security incidents along key oil gathering and export pipelines. War in Libya has brought production down to under 300,000 bpd from a historic average of 1.5 million bpd.

Insecurity in northern Iraq has caused intermittent production and pipeline outages of about 250,000 bpd. The primary goal of these countries is to get lost production back online before they agree to any deal.

Iran, an emboldened adversary of Saudi Arabia following the lifting of international sanctions, finds itself in a similar position. It has gained back market share faster than many expected from 2.75 million bpd to over 3.6 million bpd. A target of 4 million bpd is now within reach.

Long-term deals

This rapid ramp up is due in large part to long-term oil supply deals with Saras, Eni, Repsol, Hellenic, Total, Vitol and Lukoil. As Iran finalises its new petroleum licensing contract, foreign investment will come into Iran and continue to drive production growth.

These Opec members bringing back production is a stark challenge to Saudi Arabia and one it needs to manage carefully. While perhaps they underestimated the resilience of US shale, they need not underestimate the drive and realistic ability of Opec members to bring back their own production.

Until that happens, Opec members have no motivation to agree and implement the production freeze or a true production cut in the near-to-medium term.

Even if Saudi Arabia can overcome these issues and corral Opec members to agree and enforce a production cut, nothing stops the US and Russia from filling that void. US shale will see continued drilling and Russia has shown earlier this year they have no intention to cooperate with the Saudis. There's also a small issue of over 3 billion barrels (and growing) in OECD inventory that eventually will find a home in the market.

The Saudis may believe they've timed this action perfectly, that a freeze may boost oil price enough to have a meaningful impact. If Opec members have more work to do to gain back production, then a production cut isn't needed. And the Saudis can consolidate market share and turn the taps on when needed.

But as we saw in Fort McMurray — production can come offline and back online quicker than in the past. With a thin margin for market equilibrium and oversupply, any Opec member production bounce-back could foil a Saudi plan.

The writer is Vice-President Hannam and Partners, the commodities corporate advisory firm.