Post OPEC meeting note - OPEC's Greek Tragedy

Published 9 March 2020

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Last week, in our Pre-OPEC note, we wrote that it is rare to see an OPEC[1] meeting without drama, intrigue and suspense. In recent years despite all the plot twists in the drama, we ultimately saw OPEC+[2] walk out of meetings with some sort of deal, albeit sometimes only by the 11th hour. But on the 5th and 6th March 2020, the thespians of OPEC+ delivered something that viewed like a Greek Tragedy. The oil markets will feel the pain and sorrow for months to come.

A divorce in the making

The OPEC+ meeting on Friday 6th March ended in total acrimony. The press conference was cancelled and there is no official communique available on OPEC's website. Russia and Saudi Arabia's marriage of convenience is over as far as we can tell. There's simply no way to save face with a betrayal of this magnitude.

The all or nothing ultimatum

To recap, on the 5th March OPEC agreed to cut oil production by a further 1mn barrels per day if its partner countries cut by 0.5mn barrels per day (in addition to the joint 2.1mn barrel cuts already in place). On 6th March when OPEC met with its partner countries, it failed to convince Russia – its largest partner – to cut. It was an all or nothing deal. We have ended up with nothing. Even the current cuts of 2.1mn barrels will expire at the end of this month.

Oil in free-fall

Global oil markets are facing a massive demand shock from coronavirus. Instead of OPEC+ playing its role to balance the market, it will now be the source of a supply shock as OPEC+ nations reverse prior cuts.

Oil markets sank 10% on Friday 6th March.

On Saturday 7th March, Saudi Aramco (Saudi Arabia's oil producer) reportedly slashed prices in most regions between US$6-8/bbl. Many producers in the region are benchmarked to Arab Light prices and will likely follow suit.

On Monday 9th March by around 9am, oil prices had fallen a further 20%, but has opened as much as 30% lower than on Friday. This is proving to be one of the most violent price moves since the Gulf War in 1991.

The nightmare of 2014 - when oil prices fell from more than US$100/bbl to under US$30/bbl in 2016 - is coming back to haunt oil markets. That was a period in which OPEC produced without quotas. Oil futures were in contango, reflecting the glut of global production. The backwardation in oil futures markets that we have gotten used to since October 2017, was largely been due to the efforts of OPEC and its partner countries that signed a declaration to cooperate with each other in the tail end of 2016. OPEC+ slashed production by assigning individual country quotas and compliance was strong at a group level. But the flaws of the cartel were laid bare last week. The group relied heavily on a non-OPEC partner, Russia, to endorse the policy of the core cartel to make it credible. Policy divergence of this “kingmaker” threatens not only rip up the Declaration of Cooperation, but OPEC itself is under threat as member countries may open up the taps with unconstrained production as they did in 2014.

US back to being the swing-producer?

Oil prices are far too low to incentivise capital investment of any significant size. The US shale industry will likely contract. US rig counts had declined for most of 2019 and most production growth in the past year has been driven mainly by utilising wells that were drilled but capped off during periods of price strength. Between 2014 and 2016, US oil rig counts declined by two-thirds. Bankruptcies went through the roof and belt-tighteningg ensued. When OPEC was producing unconstrained, it was the US that cut back on production helping global markets move closer to balance. But it never achieved balance. On its own, we doubt the US can replace the role of OPEC as a swing producer.

Russia’s motives

We can only speculate here. Despite getting a relatively free-ride in the OPEC+ arrangement where Russia rarely cut as much it signed up to (and let Saudi Arabia do most of the heavy lifting), Russia chose not to agree to the deal last week. We suspect Russia is targeting the US shale industry. Russia appears tired of propping up global oil prices when the US frequently uses sanctions against Russia and other oil producers as a political tool.

But we feel it is an incomplete thought. We know from the last oil crisis that the bankruptcy regime in the US allows oil companies to die peacefully without any significant systemic disruption. Equally, their re-birth is swift. The US shale industry weathered shocks and become more efficient as a result. OPEC knows this, but Russia appears to want to rewrite history with another attempt at what OPEC failed to do in its 2014-2016 experiment.

[1] The Organization of the Petroleum Exporting Countries

[2] Non-OPEC Members States

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