PORTLAND MARKET REPORT

"THAT OPEC MEMBERS DESPERATELY DESIRE OIL PRICES TO RISE IS A FAIRLY SAFE CONCLUSION TO MAKE"

October update

Oil traders love to speculate. Not always the kind of market speculation that the media like to talk about, but speculation in the literal sense of the word. They speculate on whether oil demand will continue to increase, whether shale oil will bounce back, whether it will be a cold winter, what the impacts of Brexit will be and so on. But more than anything else, oil traders like to speculate on the activities of OPEC and in fact the less that actually happens on the oil markets, the more excitable the idle speculation around OPEC becomes. September was one such quiet month; prices were firmly range-bound between $45-$50 per barrel but nonetheless, OPEC speculation was reaching fever pitch.

The process started at the beginning of the month when an "informal" OPEC meeting in Paris became the centre of a rumour that a production output freeze was imminent. Prices headed sharply northwards, but soon ran out of steam as the official meeting announcements were so vague (*OPEC would make a firm commitment…to agree…on something definitely being done…at some point in the future…*) that it was clear that assertive action was not imminent. So prices tumbled back down and in fact fell below the point where the rally had started.

But speculation rarely tends to be 100% baseless and with another "informal" OPEC meeting (this time including Russia) scheduled for 28th September in Algiers, the consensus opinion is that a decisive OPEC move on production is now highly likely. The ongoing backdrop of course is the continued low oil price and the devastating effect this is having on OPEC members. State budgets have been blown and blown again in an organisation where between $75 per barrel (Saudi Arabia) and $150 per barrel (Venezuela) is required to balance the books. Furthermore, recent IEA (International Energy Agency) predictions that the current world supply glut would continue well into 2017 had most OPEC members reaching for the panic button.

At an average production cost of $15-20, such anxiety amongst OPEC members is surely misplaced? The likes of Saudi Arabia, Iran and Venezuela have some of the lowest operating costs anywhere in the world and even at $50 per barrel, profits should be handsome. But as we know, the new Millennium saw massive public spending programmes in OPEC countries and even with the riches of oil at $100 per barrel, these projects were still creating huge fiscal imbalances. So at $50 per barrel, we have fiscal melt-down. Even Saudi Arabia – the wealthiest OPEC member by far – seems to be wobbling. Analysts believe that the Middle Eastern Kingdom has dipped into its sovereign wealth fund to the tune of $350bn (of a $750bn total) and for the first time in its history, the Saudis have gone to the Bond Market (where investors lend money in return for secure interest payments) because they need to raise further funds.

That OPEC members desperately desire oil prices to rise is a fairly safe conclusion to make. But what exactly can OPEC do to deal with low prices that a) does not upset the rest of the world and b) will be effective? Clearly a full-on reduction in output would almost certainly drive prices upwards. But this would significantly upset the Western (and Eastern) consuming nations, who OPEC still need to keep on side for reasons outside of oil. Then there is the small matter of Iran, who are determined to build up production to pre-sanction levels. They would certainly not agree to a reduction and nor would Libya, Nigeria, Venezuela and Iraq – all of whom have recently experienced production drops due to geo-political instability. It would be highly unlikely that these members would see further reductions in production as the solution to their own problems. After all, it is a counter-intuitive move for bankrupt countries to reduce the output of the one thing that brings in revenue.

The other option is the much talked about output freeze. In the short-term, such a move (so long as it was officially agreed, rather than just talked about officially) would almost certainly push prices into the $50-$60 range. But after that? An output freeze would only prevent the world supply glut increasing in size and would do nothing to fundamentally address the overall supply versus demand imbalance. Plus don't forget (as if you would), the ever looming shadow of shale oil. Faced with tumbling oil prices, this part of the industry has reacted predictably by slashing costs, so that operating overheads on US shale wells have gone down by 65% since 2014. So at $50 per barrel, with much reduced labour and rig rental costs and certainly no public infrastructure projects to worry about, many of the shale oilers are actually now making a pretty decent living. If the OPEC production freeze was to become a reality, wouldn't this just be the green light for more shale oilers to come back into the market?

This of course was what the Saudi's always feared and why they have hitherto steadfastly refused to tinker with OPEC production levels. Why curtail your output when the "cowboys" in the USA are poised and ready to steal your market share? That being said, two years of eye-watering "losses" will have focused minds and perhaps the Saudis have begrudgingly accepted that whatever they do, the shale oilers are here to stay. In this light, we should see the output freeze as a way of pushing prices up to the $50-$60 price range in the short-term. This will at least give creaking OPEC budgets a bit of breathing space and of course would allow the cartel to start talking about and legitimising the next price band of $60-$70. If the shale oilers are here to stay, then talking the market upwards is pretty much all OPEC can do.

For more pricing information, see page 26

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