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CIO Viewpoint

OPEC+'s dust-up underlines supply management challenges

Investment Solutions

12 July 2021

A disagreement over the pace of restoring post-Covid oil supplies has pushed prices to a three-year high of USD 79 per barrel. As OPEC and its allies look to reverse production cuts, demand from recovering economies continues to outpace supplies, creating a challenge to oil price stability.

Chief Investment Officer, Lombard Odier Private Bank

The global economy is registering its fastest post-recession growth in eight decades, according to the World Bank. Demand for oil is therefore accelerating and the Organization of the Petroleum Exporting Countries together with allies including Russia, collectively known as OPEC+, are trying to agree how to balance supply to maintain prices.

When OPEC+ met earlier this month, Saudi Arabia and Russia jointly proposed a schedule for restoring output that would have returned production close to 2019 levels. The plan was to increase output by 400,000 barrels per day (bpd), each month from August through December 2021. In the interest of oil market stability, the proposal also included postponing the end of restrictions from April 2022 to December 2022 (see chart 1).

The United Arab Emirates, with the world's sixth-largest oil reserves, has invested in its oil infrastructure. As a result, the country objected that its recent investments were not visible in the proposals to raise OPEC+ production. Specifically, it wants its reference level of production increased from 3.16 million bpd to 3.84 m bpd. The UAE's production recovery certainly trails others': in May, its crude output was still 30% lower than 13 months earlier, while Russian production stood 8% lower over the same period.

The absence of an agreement to manage supply rises is bullish for oil prices in the short run. In theory, OPEC+ members will continue to pump oil at current levels, which already fall short of rising demand. Still, other producers, including US shale oil companies, are unable to fill the deficit in the near term, further tightening prices. Many US shale producers are under pressure to reward investors with returns rather than reinvesting in capacity, and this is a topic to monitor in second quarter earnings. Some US oil firms are also straddled with delivering on contracts signed as hedges in 2020 at as little as USD 55 per barrel.

Key takeaways

- There is no oil shortage and we retain our 12-month target for Brent crude at USD 60–70 per barrel in the expectation of a joint OPEC+ plan
- OPEC+'s disagreement over increasing oil supplies to meet recovering demand has contributed to prices reaching a three-year high
- Saudi Arabia and Russia proposed a schedule to return output to pre-Covid levels that the UAE says doesn't reflect its investments in new capacity
- OPEC+ agrees fundamentally on the need to raise production and so we expect a resolution.

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Data as of 12 July 2021 unless otherwise stated.

The OPEC+ spat pushed Brent crude prices to more than USD 77 per barrel last week, a three-year high, bringing gains since the start of the year to 49%. As we publish, the commodity is trading at USD 75.14 per barrel. That has led to suggestions that Saudi Arabia, which reversed a 1 million bpd self-inflicted cut in April, and Russia, may be impatient to increase the oil flow to markets.

Dwindling inventories

This status quo is also drawing down stocks. Declining oil supplies at the start of the Covid crisis saw worldwide inventories peak in the second quarter of 2020 at 1.4 billion barrels above their pre-pandemic levels, the equivalent of two-weeks' demand.

If OPEC were to keep supply at constant levels through the rest of this year, we estimate that excess global inventories would decline to 170 m barrels by the end of 2021, or two days' supplies. On the other hand, if the cartel returns to 2019 levels of output then the oil market would be oversupplied, inevitably cutting prices.

This is not the first disagreement within the alliance. In March 2020, OPEC called on Russia to reduce production by 1.5%. When Russia declined to back a common strategy and the Covid crisis undermined demand, the organisation's efforts to extend supply cuts failed and crude prices fell. In May 2020, OPEC+ agreed to cut production by as much as 9.7 m bpd. The alliance has slowly relaxed these reductions and cuts now stand at 5.8 m bpd.

OPEC+'s members account for an estimated 44% of the world's oil output and 82% of proven oil reserves. The grouping, assembled for the first time in 2016, increased the number of countries to 24, including Russia.

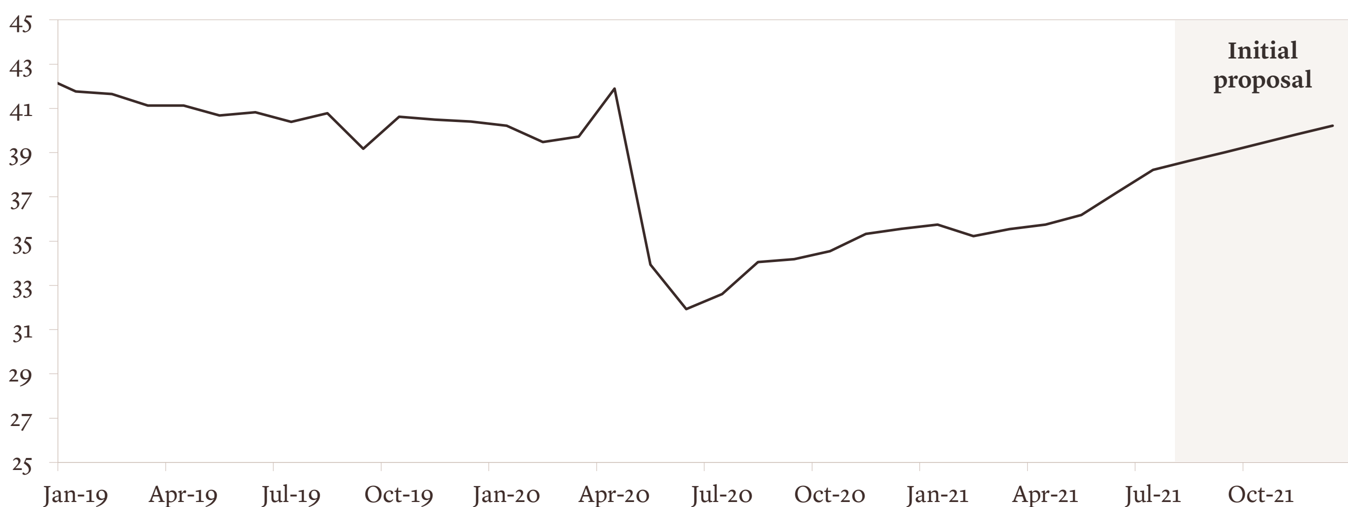
Adapting to the transition

Undersupply means that from a fundamental and longer-term perspective, the world is not running short of oil. Even once economies have fully recovered, demand growth will not return to pre-crisis levels as alternative energy sources increasingly replace fossil fuels as part of the global transition to net-zero carbon emissions. While not universally accepted, in 2019 BP, the world's seventh-largest oil company by market capitalisation, estimated that demand for oil - and coal - has already peaked.

Oil-revenue dependent producers are already taking steps to diversify their economies as the transition to carbon-free economies takes shape. OPEC, for example, hosted a workshop last week on climate change.

For the UAE, the transition away from hydrocarbon revenues has been one of the most successful among Gulf states. The country's oil industry is concentrated in one of the seven emirates – Abu Dhabi – where it accounts for more than half of the Emirate's economy. Overall, the UAE relied on the industry for a little more than one quarter of its real GDP in 2020, with the rest concentrated in tourism, financial services and high-tech industries. In comparison, Saudi Arabia relies on oil for

1. Saudi Arabia / Russia joint proposal to restore OPEC+ oil production (in million barrels per day)



Sources: Bloomberg, Lombard Odier

around 40% of its gross domestic product, and hydrocarbons account for four-fifths of exports by value (see chart 2). Russia's oil and gas exports provide more than 30% of GDP, and make up over 60% of exports.

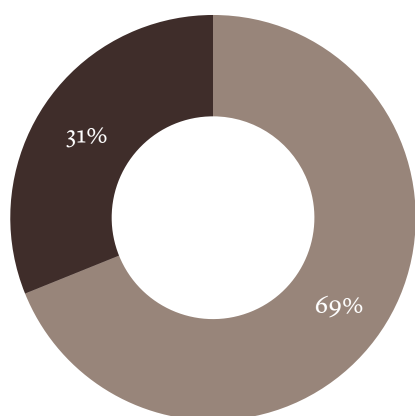
For now, the difference looks more like a temporary tiff than a rift in relations. Another OPEC+ meeting will eventually address the current impasse. The cartel's Secretary-General, Mohammad Sanusi Barkindo, said that a new date for meeting "will be decided in due course." Historically, the cartel met only twice a year. OPEC's members now know that they can be back around a table discussing the same subject within weeks. Importantly, all OPEC's members agree that they must raise production to stabilise the oil price as economies reopen. The difficulty will be finding a baseline as any concession to the UAE may open the door to other adjustment requests.

Stabilising prices

The OPEC+ alliance and its control of the oil market underlies our central scenario for oil trading in the USD 60-70 per barrel range over the coming quarters. As long as producers cannot reach a compromise, the oil market will remain volatile. As long as a large share of production remains off the market, and output is still running at less than half capacity, sustained spikes in oil prices do not look justified.

A dysfunctional OPEC+ would change our outlook. We cannot discount the risk of an increasingly fractious OPEC+ alliance, as many of its members suffer from falling market share. After the March 2020 price war, positions look clear with Russia unlikely to support any further production limits. In addition, if the dispute is not resolved quickly, US shale producers will eventually take advantage of improving market conditions to hedge additional output and increase their production capacities.

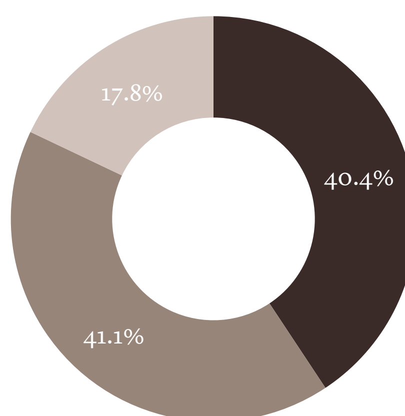
2. UAE sectorial breakdown of real GDP



Non-oil sector value-added as a % of GDP, real terms
Oil sector value-added in total real GDP

Sources: DataStream, National Bureau of Statistics, UAE

Saudi Arabia sectorial breakdown of real GDP



Oil sector / Non-oil private sector / Non-oil government sector

Sources: DataStream, General Authority for Statistics, Saudi Arabia

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