Opec’s new gambit has poor odds of success

Saudi Arabia and Russia don’t make for natural partners. Their often conflicting agendas in West Asia bear testament to that. But economic interests are a powerful motivator. The two oil-driven economies have cooperated closely on oil production cuts since the beginning of 2017. They are now preparing to go further. Last week, Suhail al-Mazrouei, president of the Saudi Arabia-dominated Organization of the Petroleum Exporting Countries (Opec), said the body is working on a plan to structure a formal alliance with 10 other petro-states, Russia being the most prominent among them. If they can pull it off, it will be the most significant restructuring of oil producers since Opec’s formation in 1960. It might not, however, be enough to achieve its goal: holding on to an eroding dominance in the face of the US shale challenge.

The 2017 production-cut deal between Opec and the other petro-states has held the line. Compliance has been reasonably good, price volatility as per the CBOE Crude Oil Volatility Index the lowest since 2014, and price levels have been high enough—approaching $70 per barrel—for investors to be bullish. The deal has now been extended to the end of 2018. But a year’s gains are not proof of future success. Several obstacles remain.

First, there is still a long road ahead. The deal has targeted a reduction in crude oversupply to its five-year target. There are still 74 million barrels to go for this. This will not be achieved in 2018. Little wonder Saudi Arabia and Russia signalled last month that the production-cut deal may very well continue into 2019. However, the longer such a deal is in place, the higher the odds that compliance will break down. *Bloomberg* notes that non-Opec compliance has started slipping this year. The track record of the non-Opec bloc’s leader, Russia, is not anything to write home about either. In 1998, the downturn following the 11 September 2001 attack, and 2008, it had been involved in production-cut deals with Opec. It failed to follow through each time.

The second obstacle—a mismatch between Saudi Arabia and Russia’s compulsions—follows from this. Together, they account for over 40% of global crude supply and are by some distance the most important actors in the deal. True, their relationship has strengthened considerably over the past year, capped by Saudi Arabia’s king, Salman bin Abdulaziz Al Saud, visiting Russia late last year. But Russia needs lower price levels than Saudi Arabia—which would prefer pricier crude given that it is listing state-owned oil behemoth Saudi Aramco later this year—to keep the fiscal home fires burning.

Saudi Arabia is also in it for the long haul. Prince Mohammed bin Salman, the power behind the throne, will need high crude prices to backstop his ambitious political and economic reform agenda. For that matter, how compliant will future Aramco stakeholders be when it comes to production cuts? Russia, on the other hand, will be sorely tempted once winter sets in and European demand spikes. This is not just about a cash grab. Edward C. Chow and Andrew J. Stanley have noted in a Center for Strategic and International Studies report that Russia has achieved a production cut by reducing drilling activity, not shutting down oilfields. In winter months, those Siberian oilfields can suffer irreversible damage if the drilling activity is insufficient.

Third, there is the 9.2 million barrels per day (bpd) gorilla in the room—the US shale industry. It upended the global oil market in the first half of this decade and nothing has been quite the same since. Saudi Arabia’s strategy to price out US drillers following the 2014 crude crash by keeping oversupply going and driving down prices has failed comprehensively. The shale industry might have been hurt, but it has rebounded. Weaker companies have been driven out and the survivors have emerged leaner and more efficient. It helps that shale is much more dynamic than conventional oilfields; drilling can be ramped up or slowed down more quickly, allowing quicker responses to the market.

All this means that Saudi Arabia, Russia and the rest are in a bind. They must cut production to push price up to viable levels. But by doing so, they cede market share to the US shale industry. It's expected to hit a record 10 million barrels per day this year, from 9.2 million. As an International Energy Agency report released earlier this month put it, "US producers are enjoying a second wave of growth so extraordinary that in 2018 their increase in liquids production could equal global demand growth." And as shale technology evolves, cost of production will decline and the economic viability of tight oil will increase, further strengthening the shale industry's hand.

In 1937, economist Myron Watkins wrote, "The problem of oil is that there is always too much or too little." Eight decades later, this hasn't changed. What has changed is that at a time when an increasing focus on renewable energy is putting pressure on the sector, the shale industry may well be better suited to tackling this inherent instability. Expanding Opec into Opec-plus will not change this.

Will Opec be able to keep oil prices at higher levels? Tell us at views@livemint.com

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