INDUSTRY ANALYSIS

OPEC and the art of the deal

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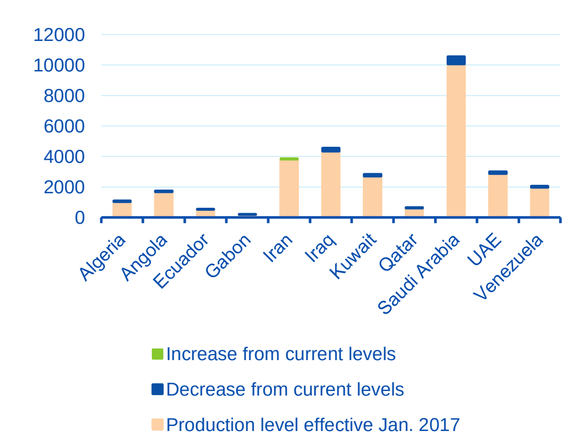
- **OPEC has agreed to cut production to 32.5 million b/d. The agreement includes an additional 600,000 barrels of cuts from non-OPEC countries to be detailed in the following weeks**
- **Implementation and monitoring could be hampered by geopolitical factors**
- **Despite its immediate positive effects, the deal should be seen as an effort to stabilize the market rather than as a measure to trigger a rapid and sustained increase in prices**

Never say never

OPEC has agreed to cut production to 32.5 million b/d. Although the market is rebalancing due to lack of investments and the decline of expensive production, OPEC's movement was primarily aimed at reducing the still-high levels of inventories. The pact will include an additional 600,000 b/d of cuts from non-OPEC suppliers, including Russia, to be detailed in the following weeks. Saudi Arabia managed to convince Iraq to cut production by 210,000 b/d, but ended up making concessions to Iran, who will be allowed to increase production by 90,000 b/d and subsequently freeze total output at 3.98 million b/d. A High-Level Monitoring Committee comprised by Algeria, Kuwait, Venezuela and two participating non-OPEC countries was established to monitor the implementation of the agreement. Libya and Nigeria were exempted from making adjustments to their production due to internal conflicts.

Figure 1

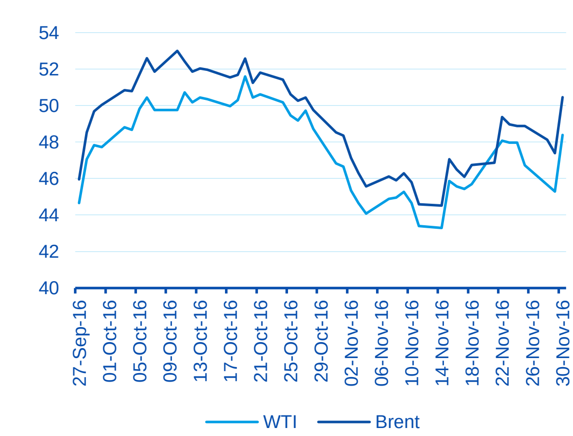
Agreed production adjustments (thous. bbl/d)*



Source: BBVA Research / OPEC *no production adjustment for Libya or Nigeria

Figure 2

WTI and Brent Spot Prices ($/bbl)



Source: BBVA Research / Haver Analytics

The deal was well received by markets, which saw it as a reassurance of OPEC's capacity to stabilize the market after the collapse of previous negotiations. The price of the benchmark Brent went up by almost 9% to $51.7 per barrel. In the following months, the agreement could bring prices into a higher range, potentially between $50 and $60 per barrel as opposed to the $45 to $53 range observed after OPEC's informal meeting in October. OPEC's production cut seems sufficient to reduce excess supply, around 1.2 million b/d. In the following weeks, the participation of Russia and other non-OPEC countries could further magnify the impact of the deal; however, the final outcome should be seen as an effort to stabilize the market rather than triggering a rapid and sustained increase in prices. In fact, the deal's efficacy to create such environment is questionable, and it could well fall short of expectations for reasons that go beyond effective implementation and monitoring.

The agreement could fail if, for example, Iraq needs more oil revenues to fight ISIS or if the incoming U.S. administration tries to disavow the nuclear deal with Iran. In both cases, these OPEC members would feel the need to increase their output in order to maximize revenue in the shortest period of time. This could increase quarrelling within the cartel which could dissuade Russia and other non-OPEC countries from cooperating. The deal's success is also questionable if higher oil prices and favorable policies from the new Trump administration, such as the lifting of restrictions to drill in federal lands and waters and the downsizing of environmental regulations, reignite investments in oil and gas and boost U.S. production in a relatively short period of time. Although U.S. production may not return to its previous peak, it could grow enough to prevent prices from soaring.

On the other hand, there is currently little upside from demand that could support a rapid increase in prices. In the short-run, the outlook for emerging markets, which are the main drivers of oil demand, is heterogeneous and weaker in general. Moreover, in the long-run, a peak in demand is possible because of improvements in energy efficiency, the fight against climate change, the development of the electric vehicles and China's economic rebalancing. Although the first three factors may be delayed by a shift in U.S. energy priorities, they are most likely to persist.

Bottom line

Although the OPEC deal is expected to have a positive but moderate impact on prices, it will certainly provide relief to several producing countries, reducing the probability of economic crisis and social unrest. On the corporate side, it will boost the value of energy assets and prevent further adjustments in CAPEX and cost structure. It would also send a positive signal to capital markets which had distanced themselves from a troubled oil and gas industry.