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OPEC's Misleading Narrative About World Oil Supply

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At a time when energy market headlines focus mainly on OPEC cuts, observers may be forgiven for concluding that a supply crunch and higher prices are imminent. On the contrary, there is still too much oil in global markets. In this context, OPEC production cuts (which notably fall short of the original target envisaged by the organization) appear to serve mainly as a psychological support to oil prices.

Analyzing trends from my proprietary database of more than 1,200 global oilfields helped me to make a **bold prediction** in 2012 regarding a coming oil supply boom. In January, my similar field-by-field analysis indicated that world oil production capacity and actual production were still growing—while prospects for demand growth were not sufficiently high to absorb the excess supply. In particular, actual oil production (which includes crude oil and other liquids such as condensates, NGLs, and more according to the standard definition used by most statistics) was almost 99.5 million barrels per day (mbd)—leaving a voluntary and involuntary spare capacity (the result of local civil wars and other geopolitical factors) of more than 4 mbd.

This surprising level of oil availability is a consequence of the impressive acceleration of world oil production that began between September and October 2016 and culminated in December 2016 and the early weeks of January 2017.

Over that period, oil production increased almost everywhere in the world. Non-OPEC countries such as the United States, Canada, Brazil, and the North Sea Region registered a combined increase of oil output of almost 1 mbd versus their September 2016 production levels. The Russian Federation hit another post-Soviet record of production, reaching 11.2 mbd. Even OPEC countries dramatically increased their production, which ballooned from an October baseline of 30.9 mbd to more than 33 mbd.

These last figures are the key to understanding why OPEC cuts are not sufficient to rebalance the market.

When those cuts were devised in late November 2016, OPEC intended to cut its own total production by 1.166 mbd (effective January 1, 2017) from the October 2016 baseline of 30.9 mbd—which implied targeting a production of 29.8 mbd to be reached in the first six months of 2017. Now several representatives of OPEC are claiming that compliance with the agreed cuts is exceeding expectations—and this may be partially true: according to direct communications between OPEC countries and the OPEC Secretariat, cuts may indeed have reached almost 1.2 mbd, although an official OPEC Report in February (based on secondary sources) stated that cuts were only 890,000 bd.

Focusing on such figures, however, is misleading.

The reason is simple. As we have seen, OPEC production grew dramatically between October 2016 and January 2017: even accounting for a 1.2 mbd cut, in January 2017 the organization was producing almost 31.8 mbd. Thus, in order to meet the original 29.8 mbd target, *OPEC should cut 2 mbd more*.

And things are even worse for those 12 non-OPEC producers that agreed to make oil output cuts together with OPEC. Their commitment was not overwhelming (as a whole, less than 600,000 barrels per day), yet their level of compliance with that target was less than 60 percent in February.

All of this leads me to suspect that the global oil market remains highly vulnerable to the actual status of oil supplies. There's a paradox: so far, OPEC's effort to convey the message of an exceptional level of compliance with cuts has helped sustain oil prices—but in so doing it has also incentivized oil output increases in many countries.

The United States is by far the main beneficiary of such price support. In early February, almost

all US shale oil producers have presented plans to strongly increase their shale oil output in the course of 2017. This is a realistic prospect, because all those producers have a massive backlog of already drilled wells that are just waiting to be completed to start production. And it's plausible to expect that US shale output will accelerate after the winter months, which usually pose major obstacles to shale production. Other countries are still completing investments to develop new productions or re-develop mature oilfields. These investments began in the "golden years" when oil prices exceeded $100 per barrel and cannot be stopped now that the bulk of the original budgets has already been spent.

This scenario of an enduring excess supply could be eased by a robust demand growth. But preliminary data and analyses do not portend such a development, especially because of a significant slowdown in demand growth in China and India—the two major engines of world oil consumption growth.

China National Petroleum Corp. (CNPC) Research Institute of Economics and Technology forecast that net crude imports would reach 7.92 mbd in 2017—versus 7.5 mbd last year. The forecast pace of growth represents a big slowdown with respect to the 13.1 percent CNPC reported for 2016.

As to India, prime minister Narendra Modi's decision to ban the use of 86 percent of the cash supply (the so-called demonetization of India's economy) should have a knock-on effect for oil demand, which could also be dented by the government's commitment to tackle air pollution by curbing fossil fuel use. All major institutions—from the International Energy Agency (IEA) to OPEC—have so far reduced their estimates of India's oil demand growth in 2017 versus 2016. Their estimates are probably too conservative. But even assuming a robust net oil import growth of almost 400,000 bd, the combined growth of China and India will not exceed 900,000 bd. Net demand growth in the rest of the world will likely be lower than 400,000 bd. Regardless, given the current oil supply framework, a potential net growth of 1.3 mbd is too meager: all other things being equal, that figure would need to double to remove enough oil from international markets. Unfortunately, such growth is rare: in the past 30 years, it happened only in 2003 and 2004.

To make matters worse, a heavy global refinery maintenance of around 3 mbd—concentrated in March and April—would lower crude demand and could add to temporary crude builds. When it starts to ease, the OPEC and non-OPEC cuts will be close to expiration—June 30, 2017.

Clearly, we still need more data and elements in order to make a sound assessment of what will

actually happen on global oil markets in 2017. But it's not too early to raise a red flag: there is something wrong in the numbers that circulate globally about oil supplies. And one thing is for sure: OPEC and non-OPEC cuts are not enough to re-absorb the world's excess supply. So, unless oil demand growth rebounds to record levels in 2017, oil prices could head for another substantial fall.

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