

# Le dernier mot

Jean-François Lambert dissects the repercussions of OPEC's Algiers agreement and suggests that the biggest loser could be the long reigning king of oil: Saudi Arabia



**S**o OPEC is not dead, after all? Amid a large consensus about the inability of its members to strike a deal in Algiers and after a four and a half-hour closed-door meeting, the organisation came up with an agreement. But an agreement to do what?

Well, after months of record production, OPEC members have agreed to merely reduce output to between 32.5 and 33 million barrels per day (bbl/d). The question is of course what quotas will be applied to which members. This becomes really interesting because no specific quotas have been assigned. It now transpires that some flexibility will be provided by the organisation to some of its members who are currently endeavouring to ramp-up their output. Be that post war Libya and Iraq, or post sanctions Iran.

What does this tell us about OPEC? I believe there are three points which are worth pondering.

## Tehran's right to produce

First, this is a clear victory for Iran. They did not want to discuss any production cap before they reach the pre sanction output level of four million bbl/d. In fact, they are now targeting 4.2 million bbl/d. OPEC seems to acknowledge this. This is remarkable, knowing the existing tension between Saudi Arabia, Qatar, and Iraq on the one hand, and the Persian leadership on the other.

When Saudi decided to let the market drive the oil price in 2014 and cease its swing producer role, most commentators thought that the US shale oil producers were being targeted. This was probably correct, but the move was also a direct blow to Iran,

who was trying to put its economy back on its feet through its oil production. The fact that OPEC acknowledges Iran's right to keep the spigots wide open, is an outright success for Tehran.

## The troubled Kingdom

Second, an Iranian victory is a clear defeat for Saudi and this is also remarkable. Remember when Saudi's Ali Al-Naimi, the former Minister of Petroleum and Mineral Resources said in 2014<sup>1</sup>, that Saudi Arabia could produce oil profitably at US\$20/bbl. Maybe Aramco can, but not the Kingdom of Saudi Arabia. The country's budget deficit reached 15% of GDP in 2015<sup>2</sup> and a harsh austerity plan has been imposed upon a bloated public sector. A vast plan has been engineered to reduce the addiction of the Saudi economy to oil, but is this not coming very late?

This economic fragility compounds with a challenged political clout of the Kingdom, which is more openly criticised by western democracies about the passive role it may have played in the rise of 'Islamic terror'.

## Oil has many foes

Third, while the rationale for an agreement is to stabilise the oil price at a more acceptable level for the cartel, it is doubtful that OPEC can drive the prices to stabilise well above US\$55/bbl, even with the help of The Russian Federation. OPEC and Russia now have to count with the US shale oil producers whose dynamics are not aligned. If the conventional producers reduce their output, driving prices up, the producers from the Marcellus basin in Pennsylvania, the Bakken Shale Play in North Dakota, as well as the Permian Basin and Eagle Ford shale in Texas, will boost their production.

OPEC's ability to fix the oil price is gone.

This new normal might not last forever though. Demand is still growing by approximately one million bbl/d per annum, while spending cuts of US\$1trn<sup>3</sup> will eventually pressure supply. When the supply and demand curves cross, the oil price should raise again. But when? Producers were hoping for this to happen as soon as 2017, but with China slowing down and secular stagnation spreading in the developed economies, that might take much more time.

In the meantime, we can expect more heated discussions within OPEC under the weakened leadership of Saudi and the growing influence of Iran, which will create little consensus and a diminished influence for the next few years to come. Conventional producers (Venezuela, Nigeria and Angola) will suffer more. They will no doubt tap the banking market with tight structures, but higher risks. The good news is that Iran might also need some financing to support its necessary investments. If only international banks could support them, the risk profile is so much better!

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## References

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