OPEC DEAL WITH RUSSIA IS SHOWING SIGNS OF STRAIN

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Saudi Arabia's former oil minister Ali al-Naimi complained in 2014 that Russia never followed through on its promises to reduce production during the 2008-2009 financial crisis, and he assessed the chance of cuts at zero." Under his successor, Khalid Al-Falih, Russia -- leading a group of non-OPEC states -- has engaged in unprecedented cooperation with the Saudi-guided Organization of Petroleum Exporting Countries. Rising oil prices reflect some market optimism, but strains are again showing in the deal, up for renewal or expiry in March 2018.

A failure to renew the accord would add further oversupply. Despite a bump in August, compliance is already weakening slowly. The conditions in the first half of this year were the most favorable: Russian production usually is stagnant in spring, due to weather. At the same time, Saudi domestic demand for power generation was lower, and Iraq and Iran struggled to boost output. Nonetheless, OPEC exports did not decline nearly as much as reported falls in production.

Since then, Libyan production, though volatile, has recovered substantially, while Nigerian output also came back, as both have been exempt from cuts under the arrangement. Iran has recently started exceeding its agreed cap slightly, with production inching up, while investment is returning in Iraq, which has reluctantly agreed to the deal. To meet summer domestic demand, Saudi Arabia moved from over-complying to merely complying. OPECs goal of removing 1.16 million barrels per day from its October 2016 production has shrunk to only 489,000 bpd, taking into account the two exempt countries, while exports are down just 213,000 bpd, according to the tanker-tracking service Kpler.

In June, al-Falih told other OPEC ministers, I am losing my credibility, according to the Wall Street Journal. He has been pushing OPEC to make decisions based on exports rather than production, a fundamental change to its modus operandi. This would have to include refined product, as well as crude shipments. Tanker-borne cargoes are easier to track than pipeline exports, which Russia supplies on a large scale to Eastern Europe and China. Nigeria, Iraq and others might deliberately or inadvertently see large-scale smuggling in excess of quotas. And for those OPEC and non-OPEC states that are also World Trade Organization members -- prominently, Saudi Arabia, Russia, the United Arab Emirates, Kuwait and Venezuela -- explicit export restrictions could expose them to legal action.

Meanwhile, Russia met its 300,000 bpd production-cut obligation in August, due to maintenance work at the Arctic Prirazlomnoye field, which is scheduled to be wrapped up in October. But its overall reduction in the first half of this year has been small. Russias diplomatic contribution to pulling the deal together was essential; its compliance has been better than cosmetic, but well short of what was promised.

The oil price prognostications of Russian officials do not inspire great confidence in the deals future. Igor Sechin, chief executive of the state oil giant Rosneft, has said he expects oil prices to be from $40 to $43 next year; Bank of Russia Governor Elvira Nabiullina has put them at $40 for 2018-19.

President Vladimir Putin is up for re-election in March 2018. Although he is expected to win overwhelmingly, the ballot holds some potential to air discontent. Growth is anemic but positive, and a moderate budget deficit of 1.4 percent of gross domestic product in 2018 is manageable. The weakening of the ruble, while cutting ordinary Russians purchasing power, has cushioned the government budget and made the local oil industry highly cost-competitive.

Saudi Arabia is in a weaker position. Fiscal discipline has slipped with the reinstatement in April of public-sector bonuses and allowances, and austerity has led to flatlining economic growth, which the International Monetary Fund predicts will be just 0.1 percent. The deficit shrank in the first half of this year, to 5.6 percent of GDP, but the improvement was driven by an increase in oil prices, as non-oil income was down 12 percent. The ambitious National Transformation Plan, designed to raise non-oil revenues, depends on a degree of pump-priming from government spending. The commentator Essam Al-Zamil, who had cast doubts on the Saudi Aramco initial public offering and valuation, was among 16 people arrested last week because they were perceived to be critics of the government.

There have been suggestions that the IPO of Saudi Aramco, once slated for the second half of 2018, could slip into 2019. Given the complexity of the listing, the difficulty in achieving the stated $2 trillion valuation target, and continuing uncertainty over London or New York as the venue, delay is looking increasingly likely.

Markets should look past short-term price fluctuations when valuing Aramco, but the stubborn persistence of relatively low prices sets the tone for the longer-term outlook. Riyadh may hope that, by late 2018, its production restraint strategy will finally be showing solid dividends in terms of a large drawdown in stocks and a price increase. But the longer the IPO is delayed, the longer the OPEC production deal has to be rolled over, and the greater the risk that it will erode or even collapse.

Analysts need continuing reassurance that OPEC and its frenemies, Russia foremost, are not going to engage in a competitive race to the bottom by boosting output. Their forecasts, which look optimistic, dont foresee oil reaching $60 per barrel until 2019. Even with the March cut in Aramcos tax rate, our estimates require a long-term oil price of $95 per barrel to justify a $2 trillion valuation. The OPEC cuts will most likely be extended, but the Saudis are increasingly bearing the burden of a deal they cannot afford to walk away from.

Kaynak/Source: