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Energy Monitor

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Oil prices benefit from Saudi generosity

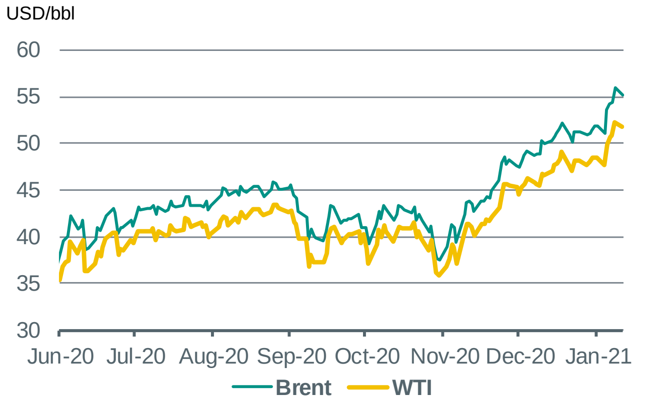
- **OPEC+ concludes agreement, Saudi Arabia reduces oil production on its own initiative**
- **Due to Russia's exceptional position, continuation of OPEC+ unanimity is at stake**
- **Oil price forecasts slightly adjusted; upward price potential is limited**
- **We do not expect oil prices to rise much further in the short term…**
- **…and the risk of a downward correction is substantial**

OPEC has reached an agreement, but not without a fight

OPEC, together with its partners led by Russia (together OPEC+), has agreed on a new production level for the months of February and March. The consultation in early this month - January - was part of the agreements made in December. At that time the agreement was made to evaluate the market on a monthly basis in order to adjust the OPEC+ production level if necessary. The - at first sight - biggest differences of opinion were again found between Russia and Saudi Arabia.

Prior to the consultation, Russia pleaded for a production increase of 500,000 barrels per day (kb/d). Saudi Arabia indicated it wanted to be more cautious because of the new lockdowns in some countries and the consequences this has for expectations regarding the demand for oil. Saudi Arabia however, advocated leaving production levels unchanged and even reversing the 500 kb/d production increase in the month of January. Last March, this led to an escalation and the opening of the oil tap. As a result, Brent oil dropped to a level below USD 20/barrel, and WTI even traded at negative prices for a while. However, this time it did not come that far. In fact, the oil price rose after the agreement was reached.

Oil prices: Support after Saudi production cut



Source: Bloomberg

The agreement implies the following. The production increase in January remains as it is. Furthermore, oil production will remain unchanged in February and March as well. There are three exceptions to this.

1) There will be relatively small production increases in Russia (+65 kb/d) and Kazakhstan (+10 kb/d) in these two months.

2) In addition, Saudi Arabia came with a surprise during the press conference. As a sign of 'goodwill', the Crown Prince Mohammed Bin Salman indicated that Saudi Arabia will voluntarily and unilaterally reduce oil production by 1 million barrels per day (mb/d) in February and March. The unofficial production target for Saudi Arabia will therefore not be 9.1 but 8.1 mb/d.

3) With this reduction in production, Saudi Arabia takes full responsibility for balancing the market as new lockdowns are set and existing lockdowns are being extended in the fight against the covid-19 virus.

OPEC+ production levels for the coming months

x 1.000 barrels

		Jan 7.2		Feb 7.125		March 7.05	
	Ref Production	Cut	Req. Production	Cut	Req. Production	Cut	Req. Production
Algeria	1057	-181	876	-181	876	-181	876
Angola	1528	-261	1267	-261	1267	-261	1267
Congo	325	-56	269	-56	269	-56	269
Eq.Guinea	127	-22	105	-22	105	-22	105
Gabon	187	-32	155	-32	155	-32	155
Iraq	4653	-796	3857	-796	3857	-796	3857
Kuwait	2809	-480	2329	-480	2329	-480	2329
Nigeria	1829	-313	1516	-313	1516	-313	1516
Saudi Arabia	11000	-1881	9119	-1881	9119	-1881	9119
UAE	3168	-542	2626	-542	2626	-542	2626
Azerbaijan	718	-123	595	-123	595	-123	595
Bahrain	205	-35	170	-35	170	-35	170
Brunei	102	-17	85	-17	85	-17	85
Kazakhstan	1709	-292	1417	-282	1427	-272	1437
Malaysia	595	-102	493	-102	493	-102	493
Mexico	1753	0	1753	0	1753	0	1753
Oman	883	-151	732	-151	732	-151	732
Russia	11000	-1881	9119	-1816	9184	-1751	9249
Sudan	75	-13	62	-13	62	-13	62
South Sudan	130	-22	108	-22	108	-22	108
OPEC 10	26683	-4564	22119	-4564	22119	-4564	22119
Non-OPEC	17170	-2636	14534	-2561	14609	-2486	14684
OPEC+	43853	-7200	36653	-7125	36728	-7050	36803

Source: Bloomberg

Decision sets precedent for future uncertainty

There are <u>three</u> risks in this week's agreement:

Firstly, Russia is now allowed to produce more. This is supposed to meet the higher local needs due to higher consumption in the winter season. But with 65 kb/d out of a total of more than 9 mb/d it is like a drop in the ocean. However, one consequence of this is that Russia gets an exceptional position in relation to the other oil producers. There are many more countries that would prefer to increase oil production. If it is not to establish market share, it is because of economic necessity to be able to continue to meet their financial obligations. During the consultations in December, the United Arab Emirates did not agree with the first proposal of Saudi Arabia and Russia. This was mainly a signal that the OPEC+ policy should be a joint policy by and for all members, and not a pre-arranged plan by the Russians and Saudi alone. This new agreement gives Russia a separate status, something that could again lead to resentment among the other oil producers and at the expense of future unity.

Secondly, Saudi Arabia has once again taken firm control with the current decision. The OPEC+ talks may have led to only a marginal increase in production, but not yet another price war in which everyone produces what they want. Yet Saudi Arabia has, on its own initiative, greatly reduced its production. In doing so, it is giving up a percentage of its market share in favour of a higher oil price. On the contrary, the Russians wanted to prevent a higher oil price in order to ensure that oil producers in the US would not get a new incentive to increase production. As a result of Saudi Arabia's unilateral decision, not only the spot price has risen, but also the forward prices. This gives US oil producers the opportunity to hedge part of their intended production for 2021 and 2022 already in the market, thus securing revenues (or at least part of the cash flows). Although there was no friction during this press conference, the US market share was the reason for the price war between Russia and Saudi Arabia less than a year ago.

Thirdly, we need to ask ourselves what the actual point is of a monthly reconciliation. The idea in December was to evaluate the market on a monthly basis and adjust the production level to the developments on the demand side (with a maximum production increase of 500 kb/d). At the very first consultation after this appointment was made, a production target was set for two months (instead of one). There will still be a meeting of the technical committee on 3 February, but it normally has no decision-making authority. It is not until the beginning of March that the ministers will again sit down around the digital table. This creates additional uncertainty for the oil market. Can the promised production levels for March still be adjusted, or not? And if so, how much is the current agreement worth?

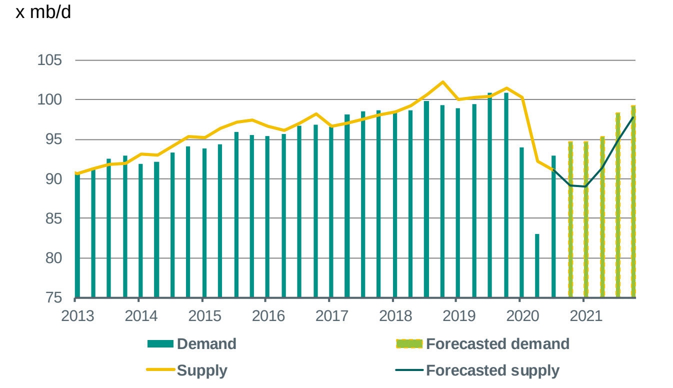
Consequences for the oil prices

For the coming months, Saudi Arabia's action has led to a significant downward adjustment of global oil supply. In addition, we see the hope that the economy will pick up again as vaccination programs slowly but surely gain momentum, thereby possibly increasing the demand for oil. As a result, the price of oil has already risen to over USD 55/barrel for Brent and USD 51/barrel for WTI. But can this move continue?

If we look purely at technical analysis, the answer is yes, the price could gain even further. The first serious resistance level is around USD 60/barrel. Only when the Brent oil price drops below USD 46.50/barrel, the positive sentiment will reverse. In addition to technical analysis, the weaker dollar and the expectation that the economy will receive an extra boost from financial support programs by governments and central banks are also seen as factors that could support the oil price even further. The economic stimulus packages will indeed lead to higher economic growth. The question is whether this will have a strong effect on the demand for oil from the current level.

There are a number of factors which will mitigate this effect. We list the three most important ones. The demand for oil will indeed increase as the economy opens up further. The main drop in demand for oil is seen in aviation. Even now that vaccination program has started, it will still take a long time before aviation gets back on track. Business travel will take longer than vacation/holiday traffic. And it remains to be seen whether business travel will return to the 2019 level at all, now that digital conferences and meetings have become commonplace. The market's expectations with regard to the expected recovery in oil demand are well ahead of reality. This can only be partly offset by a faster recovery of oil demand from other sectors such as industry and mobility in China, for example.

Global supply and demand for oil



Source: Bloomberg

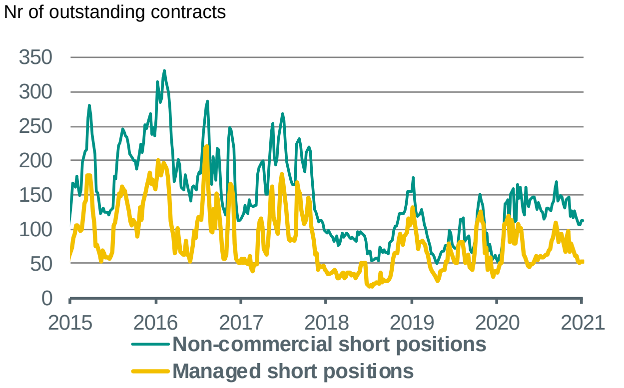
OPEC+ will produce 7,125 mb/d less in February than before the corona crisis, and 7,05 mb/d less in March. This means that the supply on the market is reasonably in line with current demand. Global inventories are still above average. But just as important is the fact that this production capacity can be deployed fairly quickly as soon as there is room for it. Russia, in particular, is keen to increase the oil production of the OPEC+ as soon as demand actually picks up and/or the oil price rises. This is in order to prevent a new imbalance in 'filling in' the market share in which oil producers in the US can account for a disproportionately large share. This limits the upward potential for the oil price.

The market is currently long positioned (speculating on price increases). And although there is still - historically speaking - room for further expansion of the position, we do not think there is currently any reason to do so. Much of the positive news has now been priced in. Should the market sentiment turn, however, there is room to build up the number of short positions and/or take profits on the long positions. In any case, the current levels ensure vigilance on opposite price movements.

Outstanding number of speculative long contracts

Source: Bloomberg

Outstanding number of speculative short contracts



Source: Bloomberg

All in all, we do not expect the oil price to rise much further in the short term and the risk of a downward correction is substantial. See table below for our updated oil and gas price forecasts.

Forecasts oil and gas prices

End of period		11-Jan	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23
Brent *	USD/bbl	*55.19*	55	50	45	50	50	55	55	55	55	55	60
WTI *	USD/bbl	*51.73*	50	46	41	43	44	48	49	50	50	52	53
Natural Gas (HH) *	USD/mmBtu	*2.60*	2.50	2.25	2.50	2.75	2.50	2.20	2.30	2.50	2.50	2.20	2.30
TTF *	EUR/MWh	*16.28*	15	14	15	17	18	17	18	19	18	17	19

Average		2020	Q1 21	Q2 21	Q3 21	Q4 21	2021	Q1 22	Q2 22	Q3 22	Q4 22	2022	2023
Brent	USD/bbl	43.21	49	53	48	48	50	50	53	55	55	53	57
WTI	USD/bbl	39.34	45	48	44	42	45	44	46	49	50	47	52
Natural Gas (HH)	USD/mmBtu	2.13	2.30	2.40	2.40	2.60	2.40	2.60	2.40	2.30	2.40	2.40	2.40
TTF	EUR/MWh	13.48	14	15	15	16	15	18	18	18	19	18	19

* Brent, WTI and Henry Hub: active month contract; TTF: next calendar year