FOCUS · The oil producer agreement: the cartel is back

OPEC is back. After eight years without reducing its production quotas, on 30 November 2016 it announced a cut of 1.2 million barrels a day, equivalent to 4% of its production, which will total, as from 1 January 2017 and providing the agreement is fulfilled, 32.5 million barrels a day. A few days later, a significant number of countries that do not form part of the oil cartel, including most importantly Russia, undertook to reduce their production by 600,000 barrels a day. These decisions were received by the market with notable price gains although some of this rally receded later. Nevertheless, by the end of December the price was 17% higher than before the decisions to reduce supply.

Although experience shows that, on average, the actual cuts following OPEC agreements tend to be 20% less than the agreed level, this occasion may turn out to be different. First of all, Saudi Arabia is taking on a substantial part of the cut (in the order of 40%), motivated by domestic factors (essentially the erosion of its fiscal revenue, on which the country's economy heavily depends). This is a complete turnaround from the previous Saudi strategy to keep supply plentiful in order to eliminate its less profitable rivals (shale but also other conventional producers). The second factor that makes it more likely this agreement will be complied with is the setting up of a monitoring committee made up of three OPEC members and two non-OPEC oil-producing countries, which will keep an eye on the implementation of the agreed cuts. Sources considered to be more objective will also be used to monitor the trend in production. Such transparency and control are unprecedented in the cartel's history.

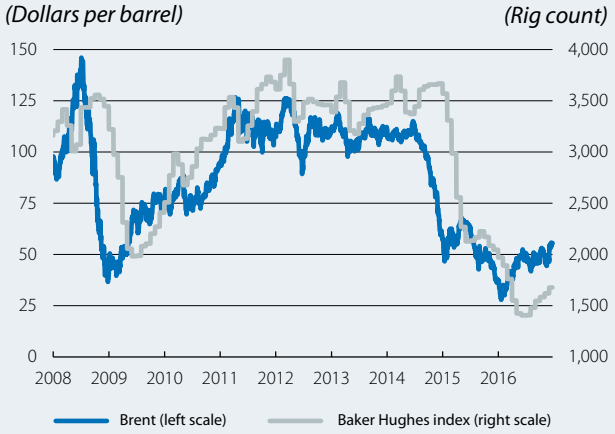
Assuming, therefore, that this agreement is reasonably credible, a second aspect that helps in its evaluation is to analyse what it represents in terms of the future global supply of oil. Although it may seem paradoxical, cutting production will not stop the global supply from remaining close to its historical peak in 2017. Based on forecasts by the US Energy Information Administration (EIA), world oil production in 2017 will be, at most, around 700,000 barrels a day less after the agreement (out of a global production of 97.42 million barrels), since the agreed cut will be partly offset by growth from countries not covered by the agreement, including the US, whose production will see a notable rise of 6% in 2017.

This improvement in US production points directly to shale, a production technology that is on the rise and makes the expected supply scenario more uncertain. The EIA is not very precise in this area but it does mention one key aspect that most analysts agree with: if oil goes above 50 dollars a barrel, shale producers will reactivate their supply.

Given this situation, although many shale sites are not considered to be profitable below a price of 65-70 dollars, the latest analyses suggest that a lot of the new sites are profitable in the 60-dollar zone or even below this, since shale production is undergoing substantial innovation, in addition to benefitting from falling prices for basic inputs such as cement and steel. These estimates are consistent with the fact that production by existing shale sites has recovered strongly in the last six months (see the graph). We should also note that the number of already drilled but not fully operational wells is high, suggesting a notable response capacity among shale producers to any slight improvement in the price of oil.

In short, the adjustment in oil supply agreed by OPEC and other producers is not disproportionate but neither is it negligible. Without this first step, growth in supply in 2017 would have probably pushed oil prices down even further. But it might have the effect, undesirable in the eyes of OPEC, of encouraging a complete resurrection of shale. Nonetheless, it adds support to scenarios forecasting a gradual improvement in oil prices in 2017, as in the CaixaBank Research scenario which predicts growth in the price of crude oil towards the 60-dollar zone by the end of 2017.

Oil prices and global shale production indicator



Source: *CaixaBank Research, based on Bloomberg data.*