

OPEC+ deal: Not so fast

The OPEC+ alliance has agreed to cut oil output by 10MMbbls/d starting in May, however, this is conditional on Mexico accepting its allocated cut. So far, they don't appear willing, and until there is a concrete deal our price forecasts remain unchanged



President of Mexico
Andres Manuel Lopez
Obrador, Mexico City

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Big cuts are coming... but how big?

Surprisingly OPEC+ managed to agree on sizeable production cuts, with the plan to cut oil output by 10MMbbl/s for two months starting in May. These cuts will then be reduced to 8MMbbls/d from July through until the end of this year, and then finally from January 2021 through until the end of April 2022 the group will cut by 6MMbbls/d. The group will next meet on 10 June to decide if any further action needs to be taken.

The reference for cuts would be October 2018 production, whilst for Saudi Arabia and Russia, their baseline for cuts will be 11MMbbls/d. Iran, Libya and Venezuela once again will be exempt from the deal.

The key issue holding up the deal at the moment seems to be the

fact that the Saudis are keen on Mexico cutting their share

This deal is conditional on Mexico agreeing on its allocated cut. Under the deal they would need to cut by 400Mbbls/d, however, they are only willing to cut by 100Mbbls/d. While the US has said it would make up for the shortfall from Mexico through organic declines, it does seem as though the Saudis are keen on Mexico cutting by their share. This seems to be the key issue at the moment holding up the deal.

Assuming that Mexico finally agrees, or others agree to the US making up for Mexico, it is important to point out that this is not a 10MMbbls/d cut from 1Q20 levels. Given that output was higher during the reference month for this deal, the effective cut from 1Q20 levels is more in the region of 7MMbbls/d over May and June, and then around 5MMbbls/d for the remainder of the year. So while the cuts are significant, they are not as big as the headline numbers suggest, and therefore not as bullish as one would imagine.

What are the issues with deal?

The biggest issue is that this deal is still conditional on Mexico joining, something that OPEC+ is still working on. If Mexico refuses to cut its share by 400Mbbls/d, it does look as though the US is willing to make up for the Mexican shortfall with their organic declines. Meanwhile, if Mexico was to pull out of the deal, it shouldn't be too difficult to allocate their cut among the remaining members, given it is just 400Mbbls/d of cuts initially.

The next issue comes down to compliance. The bigger the cuts, the larger the risk we see some producers falling short of their quota such as Iraq

The other problem is that OPEC+ have taken too long to get to this point. Cuts are set to only start in May. The issue is that we are seeing significant levels of demand destruction right now - and these cuts are still falling short of bringing the market to balance over 2Q20. So we are still set to see a sizeable inventory build over the quarter, which should keep the market at depressed levels.

The next issue comes down to compliance. The bigger the cuts, the larger the risk we see some producers falling short of their quota. Iraq failed to comply with its quota under the previous deal altogether, and under this new deal, they have agreed to cut by around 1MMbbls/d over May and June. Clearly, given Iraq's performance with the previous deal, the market cannot have much confidence that they will comply with these cuts.

What about other oil producers?

After the OPEC+ meeting, G20 energy ministers also met, and expectations were that we would see an additional 5MMbbls/d of cuts from other producers to help bring the market to balance. However, the communique from the G20 meeting fails to mention any cuts from other producers. Instead, there were promises "to take all the necessary and immediate measures to ensure energy market stability."

While we may see some mandated cuts from other producers, it appears that the bulk of the decline in output will be market-driven rather than mandated.

The US energy secretary believes that US output could fall by 2MMbbls/d by the end of 2020, while the US Energy Information Administration's latest short-term energy outlook forecasts that US oil output in December will be around 1.6MMbbls/d lower than March estimates. Output declines from the US will be gradual rather than immediate, and so not offering as much relief in the very near term.

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