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MACROCOSM

It's Official: OPEC Wants $100 Oil

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Michael Warren

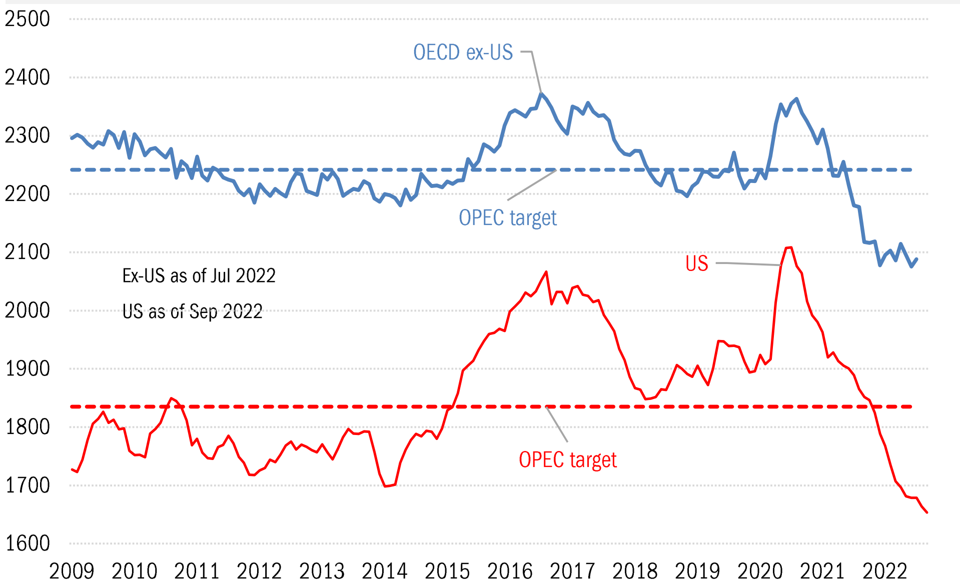
After a single month of catering to Biden, Saudi is back to driving oil prices higher.

Crude oil prices have been drifting lower – they feel a lot lower versus the short-lived peaks in early March, $140 for Brent and $130 for WTI. Nevertheless Brent has averaged almost $100 throughout the quarter, and *we think today's lower prices – as of this writing, Brent is at $88 – will not be sustained*.

Explaining the dip in prices, there are various demand-destruction narratives that range from plausible (recession fears, pump-price shock, and China lockdowns) to the risible (conversion to electric vehicles). Fair enough, but *we think the most salient issues are on the supply side, and they point to higher prices*.

- Earlier this month OPEC announced cuts to production quotas for the first time since July 2020 (this reversed after a single month the 100,000 barrels per day quota increase announced after President Joseph Biden's visit to Saudi Arabia – see "Biden Pivots on Oil, Or

Oil stocks, commercial plus official (millions of barrels)



Source: JODI, DOE EIA, TrendMacro calculations

Update to strategic view

OIL: Today's relatively low oil prices – far below the March peaks – are unlikely to be sustained. The reversal by OPEC of the expanded quotas in the wake of Biden's visit signals the cartel wants higher prices, and has abandoned its policy of worrying about historically tight OECD stocks. This implies a cartel price objective of something like $100 Brent. Whatever effect the release of oil from the US Strategic Reserve might have had has run its course. The reserves implicit in US drilled but uncompleted wells are gone, too. Yet the administration continues to discourage exploration and new production. Tight supplies from Russia and Saudi began well before the invasion of Ukraine. Russia is pivoting away from Europe and the developing world as its export market, preferring developing economies not committed to utopian dreams of decarbonization.

[Strategy dashboard]

At Least on Saudi Oil" June 22, 2022).

- *The significance in this move is the confirmation that OPEC is satisfied with today's current very low OECD inventory levels* – similar to, but indeed even tighter than, those that existed when oil prices averaged above $100 for all of 2011 through three quarters of 2014 when global consumption was lower (please see the chart on the first page, and "Data Insights: Oil" September 12, 2022).
- That turned out to be a price-umbrella under which the United States was able to finance the fracking revolution – with such success that OPEC had to respond in 2015 by removing quotas entirely and producing at will (see "Oilmageddon" December 16, 2014). When *that* succeeded to a fault, lowering crude prices to the $20's in early 2016 (but failing to put US frackers out of business – see "Oil: Priced for Perfection in an Imperfect World" January 20, 2016), OPEC reimposed production quotas to restore prices.
- Quotas were tightened dramatically in early 2020 when pandemic-related global lockdowns destroyed global demand (after an abortive production war between Saudi Arabia and Russia – see "Just What We Didn't Need: An Oil Price War" March 8, 2020). Since July 2020 when global lockdowns started to be eased, the OPEC 10 (the members that have taken part in the current iteration of the OPEC+ production agreement) have increased quotas from 20.5 million to 26.5 million barrels per day – until now.
- *And while quotas have increased, production hasn't kept pace*. OECD inventories fell well below the cartel's enshrined in the original 2016 production cut agreement.
- Currently OPEC 10 is producing about 1.2 million barrels per day below its quota. Indeed, it has been doing so since the fourth quarter of 2021. *We think OPEC is signaling to global crude oil markets that $80 Brent is too low, and that $100 is now an unofficial price target* (see "Ukraine: A Pawn in Putin's Energy Survival Strategy" July 11, 2022).
- Meanwhile, President Biden has lowered inventories further by continuing to draw from the US Strategic Petroleum Reserve, the largest pool of inventories in the world. This is a *tactical* response to the higher prices driven by OPEC under-production – you can't prove it one way or another, but perhaps it has had something to do with the recent downtrend in crude prices. But with complete certainty, *strategically*, it makes the US even more vulnerable in the future unless supplies somehow increase (perhaps especially vulnerable considering the unusually risky geopolitical environment). There's a reason they call it the "Strategic" reserve, not the "Tactical" reserve.
- A *strategic* US approach would be to encourage more domestic production – but the Biden administration's policies are *dis*couraging that. It is only in the Permian Basin that US production has been restored to its pre-pandemic levels – and even that has been achieved largely by drawing down the "fracklog" of drilled but uncompleted wells (again, see "Data Insights: Oil"). As with draws from the SPR, you can only do that *tactically*; it is not a long-term *strategy*. For now, US DUCs are just another pool of inventories

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that has been drawn down – and must be replenished (see "The Mighty DUCs Are Gone" September 29, 2021).

- *While the war in Ukraine super-charged oil and natural gas prices in February 2022, both had been rising since OPEC 10 started to miss its production quotas and Russia started to reduce natural gas flows to Europe in the fourth quarter of 2021*.
- Remember, ever since Russia led producing countries into the 2016 OPEC+ production cut agreement, Russian President Vladimir Putin and Saudi Arabian Crown Prince Mohammad bin Salman have formed a close relationship.
- *Is it just a coincidence that both countries reduced energy flows (Russian gas to Europe and OPEC production to the globe) at the same time, months prior to the invasion of Ukraine?*
- In the last week of September 2021, Russia supplied 40% of European natural gas – or 3 billion cubic meters per day through four pipelines. And OPEC members adhering to the OPEC/non-OPEC production agreement were producing slightly over quota.
- But then the next month, October 2021, Russia started to reduce gas flows to Europe through its four pipelines. With the complete stoppage of Nordstream after the first week of this month, Russian natural gas exports to Europe have fallen to 0.5 billion cubic meters per day – an 80% reduction. Now the seeming sabotage of both Nordstream pipelines suggest that Russia is planning to completely scuttle natural gas flows to Western Europe.
- The OPEC 10 also started to miss their production quotas after October 2021. OPEC 10 went gradually from overproducing late last year to underproducing their quota by 1.2 million barrels per day last month.
- Going forward – regardless of the Ukraine outcome – it appears obvious to us that Russia is pivoting away from Europe to supply more oil and gas to developing markets around the world, where they do not face the secular headwind of utopian dreams about decarbonization. In the near term, developed-world sanctions have targeted Russian oil and gas industry due to the war against Ukraine and tougher Western sanctions kick in at the end of the year (see, first, "A Very European Ban on Russian Oil. Maybe." April 18, 2022). So unless there is a speedy and virtuous end to the war in Ukraine – and the sanctions, too – oil supply disruptions are almost a guarantee. And Saudi doesn't appear willing to push OPEC to supply more oil to markets – at least not at these prices.

Bottom line

Today's relatively low oil prices – far below the March peaks – are unlikely to be sustained. The reversal by OPEC of the expanded quotas in the wake of Biden's visit signals the cartel wants higher prices, and has abandoned its policy of worrying about historically tight OECD stocks. And whatever effect the release of oil from the US Strategic Reserve might have had has run its course. The reserves implicit in US drilled but uncompleted wells are gone, too. Yet the administration continues to discourage exploration and new production. Tight supplies from Russia and Saudi began well before the invasion of Ukraine. Russia is pivoting away from Europe and the developing world as its export market, preferring developing economies not committed to utopian dreams of decarbonization.