ابيكورب
APICORP

APICORP ENERGY RESEARCH

Vol. 03 No. 09 | June 2018

MENA Supply: Robust performance amid tense geopolitical environments

The international energy community has always paid attention to geopolitical developments across the MENA region, but a more recent tightening of the market and the risk of greater volatility has brought this into sharper focus. Against all odds, MENA OPEC supply has performed well despite a heightened geopolitical environment. Iraq managed to continue increasing production even whilst battling so-called Islamic State, Iranian output recovered following the lifting of sanctions and Libyan production returned to 1m b/d this year for the first time since 2013. The investment seen has been promising as rig counts increase, with the UAE and Kuwait announcing ambitious capacity targets for 2022 that could see them invest over $220bn in the energy sector. But the US decision to re-impose secondary sanctions on Iran has fuelled an already deteriorating geopolitical landscape. Gulf producers can meet supply disruptions; but this will reduce OPEC's effective spare capacity. Without a substantial buffer in a tightening market, the geopolitical risk premium will return, as the impact from supply disruptions is more profound.

The oil market has enjoyed a period of excess supply for several years, which reduced the impact of geopolitical risks and supply disruptions on oil prices. Since the second quarter of 2014, crude supply began to overtake total demand resulting in an imbalance that reached 1.5m b/d in 2015. The imbalance continued well into 2016 and 2017 – though narrowing – and resulted in record levels of stock build. The Organisation for Economic Co-operation and Development (OECD) commercial stocks increased from around 2,640 million barrels (mb) in May 2014 to a peak of 3,110mb by July 2016.

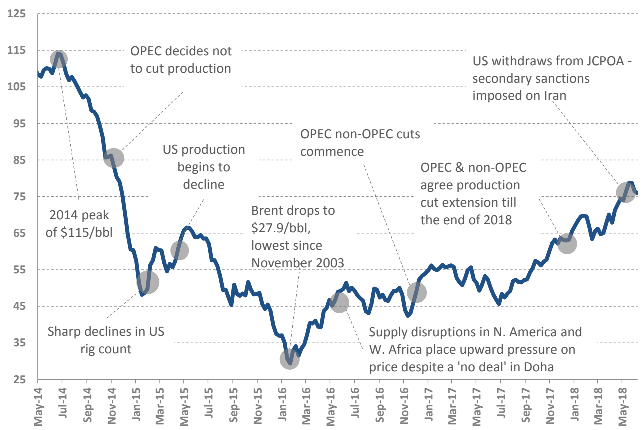
But strong demand over the past two years saw consumption increase from 95.2m b/d in January 2016 and reach 98.5m b/d by the end of 2017. Against this backdrop of strong global demand for oil and restricted supply due to sustained OPEC and Russia production cuts of 1.8m b/d and unplanned outages in some key producers, OECD stocks have fallen back in line with the five-year historic average. In such an environment of lower stocks and low spare capacity and a heightened geopolitical backdrop, the so-called geopolitical risk premium is back in the market.

Middle East: not all bad news

Following the Arab spring that began in December 2010, supply in several MENA countries was severely disrupted, and coupled with Iranian sanctions, led to substantial losses from the region that contributed to a rise in oil prices.

In Syria and Yemen, exports dropped to zero, whilst in Libya, output fell from above 1.5mb/d in 2011 to as little as 220kb/d by mid-2014. But high prices inevitably led to strong supply response, mainly from the US. With a contraction in global demand growth, the market became unbalanced, leading to a steep decline in oil prices that saw Brent dip below $30 a barrel in January 2016.

Brent price – historic ($/b)



Sources: Bloomberg; APICORP Research

Despite low oil prices and a deteriorating geopolitical environment, the supply picture in MENA has been positive as early as 2015. Following the lifting of sanctions in 2016, Iran managed to surprise by increasing output from 2.9mb/d in 2015 to 3.8mb/d today, surpassing pre-sanction levels of 3.6mb/d.

Iraq's ability to withstand both domestic and global turbulence and its resilient crude production has surprised many industry observers. Despite heightened security during the war against so-called ISIS, as well as a series of above and below ground hurdles, Iraq continued to increase its output from the south well into 2016 to reach a record 4.6mb/d. Shortly after the defeat of ISIS, however, territorial disputes between the Kurdish Regional Government (KRG) and Baghdad re-surfaced that ultimately led to Baghdad retaking Kirkuk in October 2017 and the KRG losing 280k b/d out of the total 610k b/d it produces. By contrast, the disruptions in the north were small and were offset by an increase in output from the south.

Mustafa Ansari, Senior Economist | mansari@apicorp-arabia.com | +966 (0) 13 859 7119
Ghassan Alakwaa, Senior Economist | galakwaa@apicorp-arabia.com | +966 (0) 13 859 7120

Even Libya, against all expectations, managed to increase its production. Having stalled in the range of 300-700k b/d for several years, output in the second half of 2017 reached 900k b/d and later exceeded the 1m b/d mark in the first quarter of 2018. In 2016, Saudi Arabia increased its production by 500k b/d between January and the production cut agreement in November, whilst Iraq increased its production by 350k b/d over the year. Meanwhile, the stable GCC producers maintained production at record levels and output only declined as a result of the agreement to cut production in November 2016.

November 2016 production cut agreement (k b/d)

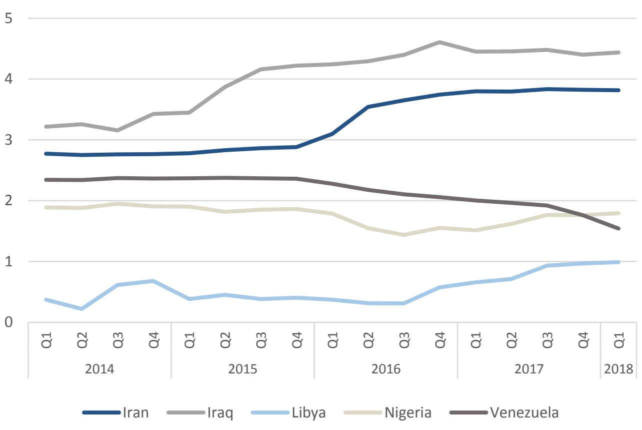
	Reference production	Agreed adjustment
Algeria	1,089	-50
Iran	3,975	90
Iraq	4,561	-210
Kuwait	2,838	-131
Qatar	648	-30
Saudi Arabia	10,544	-486
UAE	3,013	-139

Source: OPEC

The combined cuts under the agreement would effectively take out 1.8mb/d from the market with non-OPEC countries led by Russia, contributing 600k b/d of the total. Within OPEC, Saudi Arabia accounted for the largest bulk at close to 490k b/d - although compliance has been better at above 120% - followed by Iraq at 210k b/d. Whilst Iran was allowed to increase production by an additional 90k b/d. However, parts of these cuts were offset by increases from Libya and Nigeria, who were also exempted from the agreement.

Overall, MENA OPEC supply has performed well despite the rise in geopolitical tensions. The main concern for the market has been outside MENA, particularly Venezuela and to a lesser extent Angola, whose fields are maturing and nearing depletion. In Venezuela – now widely seen as the highest risk to the oil market - production has not recovered since the end of 2014 when it stood at 2.4mb/d, and has shrunk to reach 1.4mb/d as recently as Q1 2018, with the downward trend expected to continue. Production in the country is at a 30-year low. With high debt, rising inflation and deteriorating equipment and labour shortages, Venezuela's production could see further output losses by year-end.

Selected OPEC member production (m b/d)



Source: OPEC

The investment scene has not been bad

Beyond the issue of output disruptions, the region has also continued to invest in the sector. Iraq, the UAE and Kuwait all have ambitious plans to increase productive capacity, with MENA rig counts reaching a record 408 in February 2018, signalling a higher resilience to geopolitics in the energy sector.

Earlier this year, Iraq announced a revised capacity target with the aim of reaching 6.5m b/d by 2022. In the first quarter of 2018, the country's rig count reached 58, 17 higher than the same period last year and has been the main contributor to MENA's overall rig count. On April 26th 2018, the government of Iraq held a licensing round for 11 of its blocks. While it failed to attract any of the world's major oil companies, it did manage to offload six blocks – three more than the previous round held in 2012. More, the five blocks that failed to receive a bid were also purely exploration blocks, whilst three of the awarded blocks (Khashm Al Ahmar, Gilabat-Qumar and Naft Khana) are in high security risk areas, signifying the risk appetite of some of the international firms.

Kuwait has also announced plans to invest $112bn in the next five years to boost production and is hoping to increase oil capacity from 3.2m b/d at the start of this year to around 4m b/d by 2020. This comes after the UAE announced plans back in November 2017 to invest $109bn in the sector until 2022 with the hope of initially increasing output to 3.5m b/d by the end of 2018. In April, ADNOC also invited bids for exploration contracts for six blocks with untapped oil and gas reserves, having attracted major oil companies in the ADCO concessions last year.

In other parts of the region, investors have been more wary. In the case of Libya, the improving production profile is not backed by a strong historical trend, having had an inconsistent production profile due to regular production outages. Total is the largest International Oil Company (IOC) operating in Libya having expressed its appetite for risk in order to secure low cost production. Although its operations in the country were hit, net output has now improved after the restart of the 330k b/d Shahara fields, with further increases expected following its $450m acquisition of Marathon's 16.3% stake in the 300k b/d Waha consortium. It is yet to be seen whether Total's approach pays off, having already had volumes stop from both Syria and Yemen in 2011 and 2015 respectively and with the outlook on its 50.1% stake in Iran's South Pars Phase 11 project looking increasingly negative.

Total's withdrawal from the South Pars field could deal the biggest blow to Iran if they do not manage to secure an exemption. Iran failed to capitalise on the international interest over the past two years and was not able to attract much needed investment despite the lifting of sanctions. This has largely been due to unattractive fiscal terms and delays in announcing the improved IPC terms. The US decision to withdraw from the Joint Comprehensive Plan of Action (JCPOA) highlights a missed opportunity for the country and has cast a new shadow over the country's ability to maintain current output. Iran's spending on the energy industry has been a mere fraction of the expected $100bn a year they targeted as part of their five-year investment plan.

Would this change?

While the region can look back at a period of robust supplies, the geopolitical tensions have worsened and there are now increasing concerns that we could see some output disruptions from the region. Libya remains a risk. The country is fragmented into localised battles, driven by loyalties along regional, tribal or even ethnic lines. Groups such as Libya Dawn, commonly regarded as the so-called Tripoli government, have in the past targeted infrastructure such as the Sidra and Ras Lanuf export terminals and forced their closure, to strengthen their bargaining position. These attacks have led to Libya's inconsistent production profile, with sporadic bursts of output followed by steep declines. For oil companies, the challenge is no longer negotiating terms with legitimate governments, but instead engaging separately with local powers to ensure access and security.

But the greatest risk to output disruption is Iran. The immediate impact of Trump's rescinding of President Obama's previous nuclear agreement saw prices rise from $76 to around $79, but they were already rallying prior to the decision in anticipation of the verdict. Iran's inability to attract IOCs has constrained its prospects for 2018 output growth, with exports unlikely to increase beyond current levels. In fact, given the maturity of some Iranian fields, growth in the medium to long term could even be negative. Output in the West Karun fields are behind target by 180k b/d while the South Pars oil field has only managed 20k b/d, 130k b/d short of its planned target.

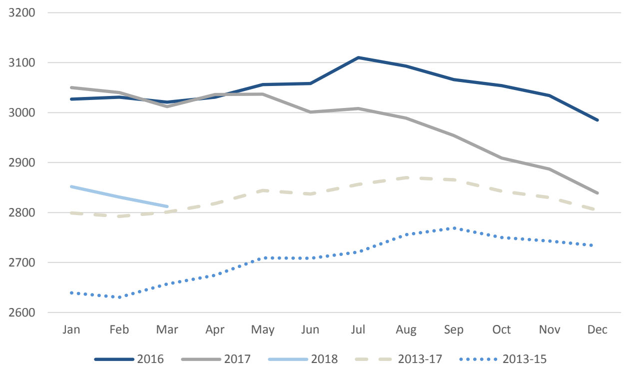
In the very short term, there is a 180-day grace period for customers to adjust until there is clarity on how sanctions will be implemented. When sanctions were initially imposed, exports dropped from close to 2.6m b/d in 2011 to a little over 1m b/d by 2014, although this is not likely to be the case on this occasion. The crucial factor will be the ability of the other signatories to the JCPOA to salvage what remains of the agreement. This will give rise to a greater penetration of Chinese companies, although China does not have the best track record, having had CNPC's contract to develop the Azadegan oil field back in 2014 terminated to due non-performance.

Tensions in the region have also heightened. Rather than being in direct confrontation, Syria has become a battleground for a proxy war between regional powers. The same is true of Yemen. Whilst both countries are not major energy producers, the risk of spillovers to neighbouring countries will keep investors at bay, which will have longer-term implications for the oil market. More pressing, on several occasions in recent months, the Houthi rebels have targeted Saudi Arabia's oil infrastructure and fired missiles towards the capital Riyadh, increasing the possibility of a direct-war between Iran and Saudi Arabia.

Given that the risk of outages has increased, Gulf producers have been sending signals that they are willing to meet any supply shortages. Saudi Arabia accounts for the bulk of OPEC's spare capacity, estimated to hold between 1.5-2m b/d that it can bring on line at relatively short notice; whilst the UAE, Kuwait and Iraq could contribute a further 1m b/d between them.

However, covering these longer-term outages would also reduce OPEC spare capacity, which according to the IEA currently stands at a little over 3mb/d. These figures are comparable to those last seen in 2014.

OECD commercial stocks (million barrels)



Source: EIA

With the prospects that OPEC may ease its production cuts, spare capacity as a percentage of total global demand – currently a little over 3% – compared to 2014 would less than halve. In a low spare capacity environment and with OECD commercial stocks down to reach the five-year average, the buffer to cushion against supply disruptions is small, placing upward pressure on oil prices and contributing to volatility.

Conclusion

Against all expectations, the supply from MENA OPEC increased by 3.85mb/d between the second quarter of 2014 and the end of 2016, with output only falling following the OPEC+ agreement. The market fundamentals over the past year have changed with stronger demand and OPEC and Russia cuts eroding the supply overhang leading to a tightened market and a recovery in oil prices. Geopolitical tensions in the region have increased particularly following the US withdrawal from the JCPOA. In light of these developments, geopolitical flashpoints in the MENA region are expected to have a bigger impact on oil price movement and market sentiment. At the same time, the region is also the only source of supply that could fill the shortage.

US shale has not been enough to balance the system, and the prospects for growth from the Permian will be constrained by the rapidly shrinking availability on the pipeline network. As a result, President Trump is increasingly putting pressure on OPEC countries to increase supplies. OPEC countries therefore find themselves forced to play a balancing act to ensure the market is well supplied without risking a market rebalance.

Comments or feedback to energy.research@apicorp-arabia.com