VIEW FROM AN OPEC-WATCHER

This economist for RBC Capital Markets and a member of the Council on Foreign Relations takes aim at geopolitics.

INTERVIEW BY LESLIE HAINES

Where are oil prices headed? Experts everywhere are grappling with this—the $64,000 question—as the industry heads into the 2018 budget planning season. Reading the tea leaves is not for the faint of heart.

Is the global oil market becoming undersupplied? After all, Venezuela's production is down about 20% from two years ago. Production in Mexico and the North Sea is faltering as well. The July report from the Joint OPEC-Non-OPEC Ministerial Monitoring Committee points to the market balancing, yet, in all the world's oil capitals, discussion whirls around the magnitude of U.S. shale supply growth this year and next.

Meanwhile, the International Energy Agency recently raised its 2017 forecast for growth in daily demand to 1.5 million barrels.

The unexpected embargo against Qatar, instigated in June by Saudi Arabia and the United Arab Emirates, is further complicating the macro outlook. Then there's the unknown effects that the sabre-rattling by North Korea may have or if the U.S. reinstates sanctions on Iran.

With so much geopolitical uncertainty, it would seem that oil prices have to rise, but that assumption doesn't hold as much weight as it once did. Observers now have to see what happens at OPEC's Nov. 30 meeting, hoping for a positive decision to continue to hold additional oil off the market until global inventories fall and supply balances with demand.

Against this dramatic backdrop of conflicting factors, Investor *checked in with Helima Croft, managing director and global head of commodity strategy for RBC Capital Markets LLC in New York.*

Croft's thesis at Princeton University, while earning a doctorate in economic history, concerned how and when countries undertake big reforms. That's coming into play now throughout the Middle East as various reform movements begin to take hold. "In the past, these countries were seen as being too rich to 'get rowdy,' but now they are facing headwinds that demand they make some changes," she told Investor.

She likens Saudi Crown Prince Mohammed bin Salman to a Silicon Valley disrupter because he is such an activist and reformer: He's hawkish on foreign policy and confronting Iran, while trying to instigate sweeping economic and social reforms at home.

"I'm dying to meet him," Croft said. "Some people say we haven't seen someone like him since the founding of Saudi Arabia."

Investor To start off and set a context, what is RBC's current price deck?

Croft We think we're going to end the year in the mid-$50s WTI. For 2017, we see WTI averaging $52.94 per barrel, ending the year at $57 in the fourth quarter, and we have Brent averaging $55.80, reaching $60.50 in Q4.

Investor Isn't this pretty bullish, given where we are now?

Croft I think it's reasonable. We still think the OPEC cuts are working, and we believe in the OPEC rebalancing thesis. On the part of the Saudis, we still see their commitment People say OPEC compliance is terrible, but the countries in the deal are complying pretty well. It's really in Libya and Nigeria, who were deliberately exempted from the deal, where production is increasing. And I always say Venezuela could solve the compliance challenge if you see more oil volumes not coming out of that country.

Investor What about global demand though?

Croft We see demand being OK; we aren't concerned about that. It's not going to fall off a cliff because Chinese demand looks pretty steady. We have some potential upside on these numbers if Venezuela defaults on some debt coming due (now and in) November—it's a very important factor to watch. We could see material production volumes rolling off, so Venezuela could solve the supply challenge.

Investor Libyan production is growing, but is that sustainable?

"If you are an OPEC planner, you have to figure out how to contend with this. Shale—and also this whole idea of peak demand—is an existential headwind for them," said Helima Croft, managing director, RBC Capital Markets LLC.

PHOTO BY CHRISTOPHER PEARCE/FAIRFAX MEDIA

“The real war on demand would be if the whole North Korean situation escalates. It’s potentially a bear story.”

Croft That’s the one thing that has given us cause for concern more than when we started this year—that Libyan production has come back stronger and more sustained than we expected. We still think it’s at risk of a reversal, but it’s really a challenge for OPEC. What do you do about these increased volumes? Libya is back up to close to 1 million barrels a day, but, at the time of the OPEC agreement last November, it was producing much less, so it was exempted from the agreement.

Investor What can Saudi Arabia do about it?

Croft What’s in the Saudi toolkit to get any of these countries to comply with a deal? Ecuador basically walked out of belonging to OPEC very publicly, and they said (it) cannot do this anymore. The Saudi fear is that, once other countries saw that, others will walk out too.

Now the OPEC cartel has to find a way to deal with this. Saudi Arabia may have to take some more barrels off the market or ask Libya to slow down. At the May OPEC meeting, which I attended, I asked the Saudi oil minister about this and he said, “Look, some of these countries have been so stressed politically, economically, socially, that we cannot try to force them.”

Libya could always go back off again. It’s such an unstable producer; they have dozens of armed actors, militias, three governments. They look like they could fall apart any time. It’s hard to say whether their 1 million a day can be sustained, so, if you are an OPEC planner, it’s hard to say what you should do.

Investor Explain how your “OPEC Watch List” works.

Croft We make an assessment on where each country is. We think about threats to their production, economic issues, political issues, and we ask, “Is this country a stable, reliable producer?” If we think you are very high-risk for a crisis that would materially affect the market, you’d get a 10 rating. Over the summer, for several countries that had low rankings, we had to up: We raised the ranking for several states in the GCC (Gulf Cooperation Council) on the back of the Saudi-led embargo of Qatar. The UAE went up even though it is internally very stable and has been ranked “most admired” in a Middle East poll, but, due to Qatar, tension in the region is elevated and everything is cloudier in terms of issues like the Muslim Brotherhood and so on.

Investor What has changed since you launched the Watch List two years ago?

Croft We’ve started to see the rubber hit the road. Until now, we’ve had this prolonged period of low oil prices, but no country has failed. No one’s really going out of business, although Venezuela does look like it may be the first sovereign country to fail. Now we’re starting to see it face a real economic and political challenge. It’s hard to see how they recover in the near term.

Investor What does OPEC think about U.S. production?

Croft The U.S. is somewhat easier to figure out—it’s about geology; it’s about price. The world that shale created has forced these governments to face this additional supply—and do things they’ve never prepared for before.

Investor Do you think U.S. shale has weakened OPEC’s power?

Croft It is something they struggle to contend with, absolutely. In December, they pulled 1.8 million barrels off the market and came up with a historic agreement with Russia yet you go over $50 for any sustained period and you get U.S. producers drilling more and hedging, and production comes roaring back. You pop over a certain number and it becomes “drill, baby, drill.”

If you are an OPEC planner, you have to figure out how to contend with this. Shale—and also this whole idea of peak demand—is an existential headwind for them, so they are having discussions that would’ve been unthinkable a few years ago.

Investor What could these lead to?

Croft A number of Gulf producing states are undertaking political reforms, such as Saudi Arabia and the United Arab Emirates that are politically challenging but very necessary, like selling down their national treasures. These OPEC countries are becoming more focused on diversifying their economies away from oil, and, then, maybe selling some assets (such as Saudi Aramco’s planned IPO). Abu Dhabi is also talking about selling some assets as well. Is Kuwait going to have to do this? They see they have to have a revenue stream separate from the oil price outlook.

And some countries, like Saudi Arabia, want to create a large sovereign wealth fund, like the UAE has, like Norway has. If a big new producer like the U.S. had not come on the scene and disrupted the market, would they be having these conversations?

Investor When do you think the oil market will rebalance?

Croft A combination of rising U.S. production plus Libya has made the rebalancing slower than they would like. The issue is: When can you get global inventories back to their normalized, five-year average? That’s what OPEC is targeting. We think it’s in Q2 2018. It’s happening now, but the U.S. will be the last market to rebalance. A lot of market participants are focused on U.S. inventory levels, but they forget about watching inventories in other places.

Investor What is the Fragile Five? Who are they?

Croft The Fragile Five is the OPEC nations we think are at the most risk: Iraq, Libya, Nigeria, Algeria and Venezuela. I don't think a country like the UAE, who we raised the risk ranking for, is at risk for any kind of social implosion. The country with the most change was Venezuela—we give them a 10, but, if I had an 11, it would be for them. They could materially impact oil production. We're concerned about the fall of PDVSA. Would we see creditors start to seize assets or PDVSA not pay their employees? Then could we see work stoppages? Does any of this impact oil the way it did in the mid-2000s due to the labor unrest they had then?

Investor Might the crisis with North Korea affect oil prices?

Croft It highlights how Venezuela could be the negative catalyst on production—to move beyond the $50 oil story, if material volumes start to roll off. But the real war on demand would be if the whole North Korean situation escalates. It's potentially a bear story, if some kind of activity escalates beyond missile tests to some kind of military engagement. We don't see that yet. But we're watching what is going on, with negative geopolitical implications for demand in Asia. It's unusual in that, normally, geopolitical events would drive up the oil price, but, in this case, North Korea is concerning for demand instead, pushing oil lower.

Investor Meanwhile, OPEC's daily output has gone up quite a bit in the last three months.

Croft Yes, and it's mainly Libya and some Nigeria. Look, these countries were deliberately exempted from the OPEC deal, but, for the countries who did sign up for the deal, compliance has been pretty good. The headwinds for OPEC are the countries that were exempted. It will have to deal with this at the Nov. 30 meeting.

Investor There have been several mini-meetings among OPEC members. What do you make of that?

Croft The recent St. Petersburg one is so fascinating to me. I could've seen Russia agreeing to make some cuts and coordinate with OPEC, but not to the full extent to which Russia actually co-piloted this agreement. You now have OPEC ministers traveling to St. Petersburg to discuss market management. It's potentially a new axis of power: Moscow-Riyadh.

They also met recently in Abu Dhabi about bolstering compliance. Iraqi compliance has been less than perfect. They have a significant portion of production within the borders of the Kurdistan government, which did not send a representative to the meeting about the original cuts, so it was always going to be a challenge for Iraq.

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Investor Talk about the significance of new Crown Prince Mohammed bin Salman.

Croft I think Saudi Arabia's policy trajectory has gone in a way I could not have imagined—to have this 31-year-old take his country in a new direction and address things we thought were sacrosanct in Saudi Arabia. He's incredibly ambitious. He combines this steely intent to remake his state—yet confront Iranian influence in the region. I love his "move fast, break things" attitude. But can you deliver economic benefits from reforms fast enough that his people think it was worth the disruption? Shrinking the state implies an initial level of pain; So much rides on this. Seventy percent of the population is under 30 and there is significant unemployment. Several years ago, people would have said, "You can't do this. You can't sell off parts of the national oil company."

But several of these OPEC countries are talking about reforms at a breakneck pace now. With a steady state of oil income they had before, they could've avoided these uncomfortable new policies.

Investor The energy world is certainly seeing a lot of dramatic changes.

Croft If anyone ever writes the book, "The World That Shale Created," it should be Daniel Yergin. But it's created a situation we've never seen before that's led these countries to say, "We'd better get our house in order."

I think the Saudis will do the IPO to get a fully funded sovereign wealth fund, which leads to some fiscal discipline and binding rules. That way, executives can't simply sell assets to cover a spending shortfall. Having a wealth fund leads to spending discipline.

One of the most fascinating trips I took last year was to Abu Dhabi, which hosted the Global Energy Forum. They also host the headquarters of the International Renewable Energy Agency (143 states are members). Abu Dhabi is very focused on increasing their own renewables mix. The gala they had during the meeting, under the auspices of their national oil company, was held at a Formula One track and everyone there drove Teslas. □

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