Trump, Iran, and the OPEC Deal: Are Higher Oil Prices Over?

Description

Oil has pulled back sharply in recent days to see West Texas Intermediate (WTI) sliding to well under US$70 per barrel and the international benchmark Brent to be trading at less than US$80. What has spooked oil markets is that the ground-breaking OPEC production deal, which began in November 2016 and saw OPEC, along with key non-OPEC oil-producing nations, including Russia, agree to cap oil production, could be unwound.

It can be argued that an advantageous moment has arrived for Russia, Saudi Arabia, and other OPEC members to unwind the deal and bring additional oil back onto the market. If that were to occur, it wouldn't be good news for Canada's beaten-down energy patch, which has been labouring under the burden of sharply weaker oil since late 2014.

In fact, despite oil's considerable rally since the start of 2018, the stock of many Canadian upstream oil producers, such as **Crescent Point Energy Corp.** (TSX:CPG)(NYSE:CPG), has failed to keep pace.

Now what?

There have already been discussions between Russia and OPEC about adding oil back into the market, as Venezuela's catastrophic production declines and higher oil prices have provided an opportune time for doing so. While many pundits point to Trump's decision to pull the plug on the Iran nuclear deal, which could see sanctions being reinstated, as being a positive catalyst for higher oil, it could in fact have the opposite effect.

The proxy conflict between Saudi Arabia and Iran for leadership of the Muslim world has been escalating for some time, and the production caps provided Saudi Arabia with a tool to limit Tehran's regional ambitions. This is because they constrained the rate at which Iran could expand its oil production, thereby limiting Tehran's ability to generate the necessary revenue and foreign investment to reinvigorate the nation's tired energy sector and beaten-down economy.

For obvious reasons, Saudi Arabia was fearful of an economically buoyant Iran, because not only would a stronger economy lessen internal dissent, but it would allow Tehran to expand military spending and regional aid. That would allow it to provide greater support to key Saudi opponents, including Hezbollah, Houthi rebels in Yemen, and Assad's regime in Syria. It would also allow Tehran to bolster investment in courting other OPEC members to support its regional ambitions, such as the influence it has built with Qatar.

Now that Trump has pulled out of the nuclear deal, the threat of an economically emergent Iran has ended, giving Riyadh a far freer hand when formulating economic and foreign policy, including how it sets oil prices.

Then it should be considered that through a series of fiscal reforms, Saudi Arabia has reduced its budget breakeven price for oil to US$74 per barrel, which is slightly less than the market price for Brent. That makes it likely that with Brent at ~US$76 a barrel, the Saudis will seek agreement from Russia and other OPEC members to open the spigots and boost production. There is every likelihood that on the right terms, Moscow would accede to such a move given that, according to analysts, Russian oil production breaks even at US$56 per barrel.

So what?

There is every sign that OPEC and Russia could very well move to expand oil production in coming months, as they seek to keep oil prices at a sustainable level for their economies, which is lower than the ideal level for U.S. shale. By doing so, they will also be able to expand oil sales and hence revenues in an operating environment where world demand for energy is increasing, as the global economic upswing continues gaining momentum. That would be bad news for many Canadian oil producers who have waited almost four years for crude to rebound.

Nonetheless, many drillers, including Crescent Point, have established hedging strategies that mitigate a considerable portion of the risk of weaker oil. This — along with cost reductions and increased operational efficiencies — should see many be cash flow positive, even if WTI dips below US$60 a barrel.

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