Analysis: As prices fall, OPEC looks to Q3 for optimism

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• OPEC officials maintain market is rebalancing
• Cut extension details still in flux
• Market has priced in extension, say analysts

The price swoon of the last few weeks has no doubt disappointed -- if not frustrated -- OPEC's 13 members, who have seen their efforts to cut production to support prices seemingly thwarted by stubbornly high inventories.

But all along, OPEC officials have maintained that their goal with the production cut deal cannot and should not be measured by how the market reacts day to day, or even week to week.

Their eyes are focused on the third quarter, when OPEC's own analysis, as laid out in its most recent monthly oil market report, estimates global demand for OPEC crude will rise to 33.13 million b/d, some 1.3 million b/d above current levels.

OPEC will issue its newest monthly oil market report next Thursday.

"The good news is that the market is moving towards rebalancing," Saudi Aramco CEO Amin Nasser said at the International Oil Summit in Paris last week. "There has also been a rapid drawdown of floating storage in the first quarter of this year. This is being driven by improving fundamentals and the OPEC deal."

Iranian deputy oil minister Roknaddin Javadi added: "I am very optimistic that good days for the oil and gas industry are ahead."

The deal, signed late last year, calls on OPEC to cut 1.2 million b/d from its October levels, while 11 non-OPEC countries led by Russia agreed to cut 558,000 b/d in concert.

To be sure, OPEC had intended its production cuts to have brought down global oil stocks to their five-year average by mid-year. That has not been the case, particularly in the US, where bloated gasoline stocks, in particular, has given the market jitters.

US gasoline stocks were 19.5 million barrels above the five-year average at 241.2 million barrels the week that ended April 28, according to the US Energy Information Administration.

Analysts with PIRA, a unit of S&P Global Platts, say the market's fretting over US inventory statistics may be overblown.

"The lack of visible stock declines have undermined oil market confidence and dragged prices lower," PIRA said in a recent note. "Market jitters are unwarranted; oil on the water is declining, OPEC output is declining and surplus stocks are declining. Onshore stock declines are inevitable, though the exact timing is tricky."

EXTENSION TALKS

The production cut deal, as signed, was to last from January to June, although ministers have said they reserve the option to extend the deal if market conditions have not been to their satisfaction.

OPEC appears to be moving towards an extension, with Saudi Energy Minister Khalid al-Falih recently saying there was a growing consensus that one was needed.

But still unresolved are the particulars of any extension -- its length, the level of cuts, and whether Libya and Nigeria, which were given exemptions from the cuts, and Iran, which was allowed a slight rise in production, will continue to receive special dispensation.

Falih has floated the idea of a three-month extension, instead of a six-month one, while Kuwaiti oil minister Essam al-Marzouq has said that if demand is healthy in the second half of the year, the production cuts may not need to be as deep.

Iraqi officials, however, have indicated they are not on the same page, having insisted the deal concerns exports, not production, contrary to the text of the agreement posted on OPEC's website.

"We are committed to the agreement with OPEC. Still, our internal demand is increasing, so our production can be increased without affecting our commitment," Naufel Alhasan, deputy chief of staff to Iraqi Prime Minister Haider al-Abadi, told Platts in Houston this week.

OPEC, along with the 11 non-OPEC deal participants, will meet in Vienna on May 25 to review the deal and negotiate any extension.

Given the resilience of US producers, who have ramped up output by some 600,000 b/d since the deal was signed, according to the EIA, OPEC may need to show the market a stronger hand with a more stringent extension, said Mohammed al-Sabban, a former advisor to the Saudi oil ministry.

This may include sharper cuts or a requirement that Libya, Nigeria and Iran join in, he said.

"The agreement extension should not be an automatic rollover, we may need to have deeper cuts," he told Platts. "The competition with American oil is going to be more severe in the coming months."

Nigeria and Libya, which have seen their oil sectors hit hard by militancy over the past year, will seek a renewal of their exemptions, even with their prospects improving recently.

Their combined production this year, while volatile, has averaged just 6,300 b/d more than October, the benchmark month that the production cut deal is measured from, according to the latest Platts OPEC survey.

Iran, meanwhile, has yet to be asked to join in the output cuts as part of an extension, "to my knowledge," Javadi told Platts.

COMPLIANCE UNREWARDED

On compliance, OPEC has performed very well.

The Platts OPEC survey for April, released Thursday, found that the 10 members required to lower output under the deal achieved 105% of their cuts.

As a whole, OPEC's total April output of 31.85 million b/d remains 80,000 b/d above the organization's stated ceiling of about 31.77 million b/d, not including Indonesia, which suspended its membership in November and is not counted in the Platts survey.

That has exceeded the expectations of many OPEC watchers, given the organization's tattered history of adhering to previous production agreements. Nevertheless, the market has stopped rewarding OPEC for its high level of compliance, amid the US shale rebound. Analysts say an extension of the cuts is already priced into current market expectations, even with prices having given up all of their gains since the OPEC/non-OPEC deal was signed.

ICE Brent futures were $48.57/b at 1015 GMT Friday, recovering from a sharp fall in earlier trading.

Even as they remain resolute on their intermediate-term goal of drawing down inventories, OPEC is likely to be mindful of 2016's price volatility when the bloc's members were engaged in a brutal market share battle.

"They'll have to extend [the deal], or the show's over," one Platts survey participant said. "The market will fall very quickly if they don't."