Special Bulletin

A Japanese Perspective on the International Energy Landscape (46) June 9, 2011

OPEC Fails to Agree on Production Quota Hike amid Deep Divisions

Ken Koyama, PhD
Director
Strategy and Industry Research Unit
The Institute of Energy Economics, Japan

"One of the worst meetings we have ever had." Saudi Oil Minister Ali Naimi used these words to describe the 159th meeting of the Organization of Petroleum Exporting Countries. As symbolized by the description, OPEC failed to resolve deep production policy divisions at the meeting and shelved a hike in production quotas (now at 24.85 million barrels per day) for 11 members excluding Iraq.

As noted in "A Japanese Perspective on the International Energy Landscape (45)," the OPEC meeting attracted the highest attention worldwide in the last few years. This was because market players and watchers had believed that OPEC actions would be important, as crude oil prices remained as high as $100 per barrel amid supply/demand and geopolitical uncertainties under great influences of financial factors. While acknowledging various policy divisions within OPEC, most experts in the world had expected that OPEC would decide to raise the production quotas by 1.0-1.5 million bpd at the meeting. The failure thus came as a kind of "surprise" to oil market players. In response, the crude oil futures market firmed, with the benchmark West Texas Intermediate crude futures price rising by $1.07/barrel to $100.74/barrel.

The first factor behind OPEC's failure to agree on a production quota hike, amid expectation for growing "Call on OPEC" under high crude oil prices, might have been differences of analyses and views on market environments and price-boosting factors. As indicated by relevant remarks after the OPEC meeting, Saudi Arabia, which called for a production quota hike of 1.5 million bpd (and such countries as Kuwait, the United Arab Emirates and Qatar supporting the hike), took a position that OPEC should send a clear signal of market stabilization by attempting to actually increase crude oil supply. But Iran, Venezuela, Algeria and Libya apparently raised opposition to the production quota hike, claiming that any production increase would not be required amid sufficient supply in the international oil market and that speculative and other financial factors would be significant for the recent crude oil price hikes.

The second factor behind the failure might have been different stances on a production quota hike (and a production expansion) and the stabilization of the market (prices) through the hike. We must pay attention to the large gap between countries that can actually expand output under a quota hike agreement and those that cannot do so. Specifically, surplus production capacity levels to enable an output expansion are important. Within OPEC, countries with significant surplus production capacity levels are limited to Saudi Arabia with a surplus capacity at 3.24 million bpd and some other Persian Gulf nations. Iran and Venezuela have little room to expand output even if quota levels are raised. Any production quota hike is meaningless for Libya whose production capacity has declined substantially because of the ongoing crisis.

Any production quota hike may not lead to a rise in oil revenues in countries that have little capacity to expand output. Instead, it could work to lower their oil revenues through price drops under an output expansion and affect their positions against Saudi Arabia that is prepared to expand output. OPEC countries in such conditions have reasons to raise opposition to any production quota hike. Meanwhile, Saudi Arabia has the surplus capacity and will to increase output and stabilize the market. As a matter of course, it is very important for Saudi Arabia to secure and expand oil revenues. An oil revenue increase has been growingly required under the recent domestic political and economic situation. Therefore, Saudi Arabia could have raised the crude oil price level that it sees as desirable. Nevertheless, maximizing oil revenues over a long term remains as the most important oil policy challenge for Saudi Arabia with the world's largest oil reserves. At a time when crude oil price hikes are growingly feared to deal a severe blow to the world economy, with the United States and the International Energy Agency placing growing expectations on a production increase, Saudi Arabia might have sufficiently recognized that it would be significant for the country to take appropriate action.

The third factor might have been the apparent impact of political tensions among OPEC countries. Amid the destabilization of the Middle East and North Africa, the maintenance of present regimes has become a matter of real concern to each country in the region. Under such critical situation, political confrontations between major OPEC countries have deteriorated or deepened as indicated by (1) Qatari and UAE responses to the Libya problem (participation in anti-Libya attacks led by Europe and the United States) and (2) the emergence of feuds and tensions between Gulf Cooperation Council countries and Iran over the Bahraini situation. In its history, OPEC had tried to separate political problems from oil policy coordination in the presence of political confrontations between member countries. The efforts had been successful to some extent. Given the abovementioned complicated and serious political conditions in the Middle East and North Africa and the emergence of political confrontations between OPEC members, however, political disputes as a key background factor might have exerted some impact on discussions at the OPEC meeting.

Although OPEC failed to form a consensus on a production quota hike at the latest meeting, Saudi Arabia is certain to increase output according to market needs, as committed by Saudi Oil Minister Naimi. In this sense, Saudi actions alone will have some effective impact on oil supply and demand, irrespective of whether OPEC has achieved an official production quota hike agreement. The next problem is the relationship between the degree of Saudi Arabia's output expansion and the future oil supply and demand trend. But the OPEC failure to produce a production quota hike has sparked doubts about the credibility of OPEC as an organization in the market and has indicated political and economic confrontations among OPEC members. These points may remain as key problems as we watch the international oil market over a long time.

Saudi Arabia's exclusive expansion of oil output can be expected to make some contributions to stabilizing the market. As noted above, however, the expansion's impact will depend on the relationship between the action, and overall supply/demand and market conditions. If Saudi Arabia increases oil output amid growing geopolitical risks in the Middle East and North Africa, the market may interpret the action as indicating a decline in the country's surplus production capacity. If a Saudi output expansion coincides with a global economic slowdown, however, it may work to drive down oil prices, as seen during the 1997-1998 Asian economic crisis, which coincided OPEC's decision to increase oil output at its Jakarta meeting in November 1997. The benchmark crude oil futures price will remain as high as $100/barrel for the immediate future. Toward the second half of this year, however, crude oil prices will have both great downward and upward risks.

Contact: report@tky.ieej.or.jp

The back issues are available at the following URL.

http://eneken.ieej.or.jp/en/whatsnew/JPOIEL.html