Special Bulletin

A Japanese Perspective on the International Energy Landscape (196) November 28, 2014

OPEC Decides not to Cut Production, Leaving Oil Prices to Weaken

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At its 166th regular general meeting in Vienna on November 27, the Organization of the Petroleum Exporting Countries decided to maintain its present oil production quotas totaling 30 million barrels per day, stopping short of lowering the quotas. OPEC's decision at the meeting had been attracting global attention at a time when the West Texas Intermediate and Brent benchmark crude oil prices had dropped to around the mid $70s per barrel after accelerating their decline since June. When crude oil prices had remained above $100/barrel long since 2011, OPEC had made no adjustment to the production quotas, leading market players to pay little attention to OPEC moves. In a run-up to the latest OPEC meeting, however, market players and media had paid close attention to its results, expecting that the oil cartel could take some action affecting the world economy after a long interval.

Crude oil price drops are a serious problem for oil producing economies dependent on oil revenues. Particularly, oil prices declined more than 30% or nearly $40/barrel from the June peaks. Such magnitude of oil price drops should have been a problem that OPEC and other oil producing countries could not shrug off. OPEC, which has played a role in stabilizing the oil market and adjusting supply and demand, seemingly had reasons to implement a production cut to stop and reverse the oil price drops. Why did OPEC fall short of reducing production?

Interestingly, most market participants and experts had expected OPEC to refrain from cutting production quotas at the latest general meeting. The result thus came within expectations, although some earlier OPEC meetings had produced surprise decisions. The largest factor behind the dominant expectations against the production quota cut was that Saudi Arabia, destined to play a central role in making and implementing an agreement to cut production quotas, had been recognized as indicating its reluctance to cut production.

Saudi Arabia's reported basic stance is that the market will naturally balance itself. The natural balancing means that if oil prices remain weak, high-cost non-OPEC oil production will stop growth and turn downward to reverse the supply and demand environment even without any production cut by OPEC or Saudi Arabia. Saudi Arabia apparently believes that OPEC or Saudi Arabia should or could naturally lead high-cost producers to shoulder costs for reducing production.

A fundamental factor behind the recent crude oil price weakness is that the international oil supply-demand balance is easing as slack growth in global oil demand is combined with sharp non-OPEC output growth. While this year's oil demand growth is estimated at a four-year low of some 700,000 barrels per day, non-OPEC oil production is increasing by 1.8 million bpd from the previous year, including more than 1.4 million bpd in U.S. oil output including shale oil. Although technological advancement has allowed oil production costs to decline substantially, crude oil prices' drop from more than $100/barrel to less than $80/barrel is expected to work to restrict growth in shale and other high-cost non-OPEC oil output. The expectations are behind the anticipated natural balancing.

The problem is the capacity to wait until the natural balancing. In this respect, Saudi Arabia has accumulated a fiscal buffer in the past period for high crude oil prices and can afford to cope with a low-price environment for a certain period of time. It is in a more advantageous position than other oil producing countries. Therefore, Saudi Arabia may be reluctant to unilaterally cut production to the advantage of other oil producing countries.

In order to implement a large-scale production cut to induce an oil price upturn, OPEC and non-OPEC oil producing countries will have to develop a mechanism for them to agree on and implement country-by-country production cuts. Saudi Arabia has a reason to be concerned that any easy OPEC agreement to cut production without such mechanism could force the country alone to shoulder costs for the production reduction. When Saudi Arabia served as a swing producer to keep oil prices at certain levels in the international market after the second oil crisis, its market share declined with its output falling to some 2 million bpd briefly in 1985 from a peak close to 10 million bpd.

As the key OPEC player, Saudi Arabia, kept from moving to make any agreement on cutting production quotas in consideration of these various factors, OPEC stopped short of reaching any production reduction agreement. This might have been a natural result in a sense. But the latest OPEC decision may force major players including U.S. shale oil producers to play the game of chicken. In other words, crude oil prices will remain weak or come under further downward pressure until some players lose their patience and withdraw from the game. The latest OPEC decision, though emphasizing the importance of monitoring the oil market and crude oil prices, fell short of indicating any extraordinary meeting and positioned next June's regular meeting as the next OPEC gathering, signaling the oil cartel's willingness to leave the market to move naturally (unless any special development comes). Given these points, the latest OPEC decision can be interpreted as having sent a considerably weak message to the market.

Actually, crude oil prices plunged after the OPEC meeting. In off-market trading when the market was closed for Thanksgiving Day in the United States, the WTI price fell far below $70/barrel and the Brent price briefly dropped below $72/barrel. Even Brent is now expected to slip below $70/barrel. Crude oil prices are likely to test even lower ground at least until the end of this year. As far as the situation remains unchanged, crude oil prices may stay weak at least in the first half of 2015.

Crude oil price drops will lead oil-linked LNG prices to decline, benefitting Japan and other countries heavily dependent on oil and gas imports. The market change anticipated in my report titled "Are We Seeing the Start of a Turning Point for International Oil/Gas Market?" (A Japanese Perspective on the International Energy Landscape (161)) has come earlier and has been greater than expected. We may have to more closely watch future international oil market trends.

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