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OPEC Decides to Ease Production Cut and Expand Production

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On June 22, the Organization of the Petroleum Exporting Countries held its 174th regular general meeting in Vienna, Austria. The oil cartel at the meeting decided to ease its joint oil production cut with Russia and other non-OPEC oil producing countries and effectively increase production from July 1 in consideration of international oil market conditions at present and for the immediate future. Under the joint oil production cut launched at the beginning of 2017, OPEC has been planning to reduce oil production by 1.2 million barrels per day. The 1.2 million bpd cut has been combined with a 600,000 bpd reduction for non-OPEC oil producing countries into a total of 1.8 million bpd. However, Saudi Arabia and other major OPEC members have cut production more than required, with Venezuela forced to substantially reduce production due to social and economic unrest, resulting in an overreduction. As of May 2018, OPEC estimated its production cut compliance rate as 152%. Under the coordinated production cut, rebalancing or the reduction of excess inventories has made progress in the international oil market, leading to a supply-demand equilibrium. The rebalancing has been coupled with growing geopolitical risks in the Middle East to push up crude oil prices. Such geopolitical risks have grown further on the United States' recent withdrawal from the Iran nuclear deal.

In May, the benchmark Brent crude oil price briefly topped $80 per barrel during the trading time for the first time since November 2014. The West Texas Intermediate crude price also rose back above $70/bbl. The January-May average price stood at $70.2/bbl for Brent and $65.1/bbl for WTI, rising by nearly 30% year on year. Given the price hikes and the international oil market's uncertain supply-side factors (a fall in Iranian crude oil exports under the resumed economic sanctions on Iran and a further production decline in Venezuela), OPEC came up with the policy to lower the production cut compliance rate to 100% to effectively expand production and stabilize the market.

On June 23, OPEC and non-OPEC oil producing countries such as Russia held a joint ministerial meeting at the OPEC headquarters in Vienna, reaffirming that they would effectively expand oil production in a manner to correct their overreduction in line with the OPEC decision on the previous day. Although specific production increases or their country-by-country breakdown were not clarified at the OPEC meeting or the OPEC-non-OPEC gathering, Saudi Arabia and some other Persian Gulf OPEC members and Russia that have capacity to increase production are expected to effectively increase production. Market participants expect that these countries could increase oil production by a total of 600,000 to 800,000 bpd or up to 1 million bpd.

The OPEC decision is seen as having been not necessarily easy. While most of the OPEC members saw some increase in production as necessary in consideration of the projected supply-demand balance, strong opposition to an official decision to increase oil production came from Iran expecting a decline in its crude oil exports on the resumption of economic sanctions following the United States' withdrawal from the nuclear deal, and from Venezuela plagued with an oil production plunge. It might have been difficult for Iran and Venezuela to accept any official OPEC decision that would allow other OPEC members including Saudi Arabia to cover drops in the two countries' oil production or in their market shares. Particularly, it was reported that Saudi Arabia has been alleged to have coordinated the production expansion decision as requested by the U.S. Trump administration that has been sensitive to domestic gasoline price hikes attributable to recent crude oil price increases ahead of the midterm congressional election. Therefore, Iran was not positioned to easily accept the oil production expansion.

As a result, the latest OPEC decision calls for effectively expanding production in a manner to correct the present overreduction and restore the production cut compliance rate of 100%, making no mention of any specific production increase or its country-by-country breakdown. The oil cartel thus reached compromise on the effective production expansion accompanied by the so-called "strategic ambiguity" to get Iran's approval and keep OPEC's unity and cooperation system. The result may also be interpreted as indicating Saudi Arabia's excellent diplomatic or negotiation skills to achieve a position in building consensus.

In response to the OPEC decision, however, crude oil prices increased. On June 22, Brent rose by $2.5/bbl from the previous day to $75.55/bbl. WTI closed $3.04/bbl higher at $68.58/bbl. Crude oil prices rose despite the decision to increase oil production apparently due to the ambiguity of the decision that left any specific production increase uncertain and indicated the possibility of an increase failing to be sufficient. Another suspected reason for such response is that a production expansion decision had been discounted into crude oil prices that were falling before the OPEC meeting. In response to the unexpectedly vague OPEC decision, crude oil prices rebounded. Responding to such market development, Saudi Arabian Energy Minister Khalid al-Falih told a press conference after the OPEC-non-OPEC ministerial meeting on June 23 that the market required some 1 million bpd in additional production. The remark including a specific figure attracted attention as a message to the market.

While OPEC and non-OPEC oil producing countries are set to effectively increase their oil production by easing their production cut from July, the future course of the oil market and crude oil prices is still uncertain. They may cautiously expand production while carefully watching market developments. The first uncertainty is how far Iranian crude oil exports would decrease. Under the pressure of U.S. economic sanctions, we will have to watch how European and Asian oil companies will take delivery of Iranian crude oil. The second uncertainty is how far Venezuela's oil production would decline. Disruptions to oil supply from some other countries like Libya would also have to be checked. The third uncertainty is how far U.S. shale oil production would increase. As crude oil prices rise, shale oil production expansion is gaining momentum. The International Energy Agency in June revised the projected increase in U.S. oil production in 2018 upward from 1.3 million bpd given late last year to 1.7 million bpd. The key point is how far the uptrend would continue or whether it would accelerate. Fourth, there are uncertainties about economic, financial and demand-side factors in addition to those about the abovementioned supply-side factors. As the United States and China escalate their trade dispute, threats are growing to the stability of the world economy. If the growing threats affect oil demand growth and stock and other financial markets, uncertainties about the oil market may increase further. Saudi Arabia and other major oil producing countries may have to closely watch developments regarding these factors in proceeding with the production expansion.

If Iranian crude oil exports decline substantially with Venezuela continuing to reduce oil production in the absence of any major turbulence in the world economy, the supply-demand gap may widen, with Saudi Arabia and other major oil producing countries with capacity to increase production being required to raise their production expansion to a higher level within the estimated range. If they increase production actually, a supply-demand equilibrium may be attained on a flow basis. Then, however, surplus production capacity may decline substantially in the international oil market, resulting in a decline in supply buffer. In such situation, the market may grow vulnerable to geopolitical risks, tending to overreact to risk events. Then, Iran's oil production would have decreased substantially, paving the way for hardliners to rise within Iran. Geopolitical risks inside and outside Iran would have grown. In such event, crude oil prices would remain high and grow volatile. Various possibilities or scenarios are conceivable about the future international oil market and crude oil prices. No optimism can be justified.

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