The “Freeze Agreement”: What does this mean?

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The benchmark West Texas Intermediate crude futures rallied above $30 per barrel in the fourth week of February after sinking on February 11 to $26.21/bbl, the lowest since May 2003, as a downward trend came to a pause. The oil market has thus been marking time in directionless trading. The first major factor behind this market trend may be that global recession fears represented by a global stock market decline accompanying the crude oil price plunge have calmed down. The Dow Jones industrial average on the New York Stock Exchange rallied from 15,660 on February 11 to 16,697 on February 25. There may be various factors behind the latest directionless trading in the crude oil market. One factor may be that market players have taken a wait-and-see attitude before finance ministers and central bank governors from the Group of 20 major countries meet in Shanghai from February 26.

A key factor behind the recent stock and oil market plunge was global recession fears linked to downside risks for the Chinese economy. As Chinese economic problems are expected to top the agenda at the G20 meeting, market players are watching market assessments and measures coming out of the meeting. The Chinese economy, though seemingly recovering its composure, is still plagued with structural problems caused by overcapacity and overinvestment in manufacturing and construction industries, as well as currency and stock market problems. The trend of the Chinese economy will continue to shake the world. Ahead of the fourth session of the 12th Chinese National People’s Congress starting on March 5, market players throughout the world are paying attention to future Chinese economic policies. Before these key events, the market is calm with price changes limited.

There is another major factor behind the crude oil market rally. On February 16, the oil ministers of Saudi Arabia, Russia, Venezuela and Qatar held a meeting in Qatar’s Doha in response to the crude oil price plunge and announced their agreement to freeze their oil production at their respective levels in January 2016 on condition that other oil producing countries cooperate in the freeze. This can be called the “Freeze agreement”. During the crude oil price plunge since the second half of 2014, major oil producing countries, including Saudi Arabia leading the Organization of the Petroleum Exporting Countries, had kept away from cutting production to defend prices. Taking the stance that production cuts would not be adopted unless OPEC and non-OPEC oil producing
countries effectively cooperate, Saudi Arabia had maintained its policy of leaving the market to price crude oil. The latest agreement calls for freezing any production expansion instead of cutting production. However, market players took the freeze agreement as indicating that Saudi Arabia and Russia began at last to address the crude oil price plunge. Such market response might have helped the WTI futures price to rebound from a low near $26/bbl to levels above $30/bbl.

Nevertheless, many market players doubt the effectiveness and feasibility of the freeze agreement. The first problem with this agreement is that the effects of the agreement would be limited even if it is implemented. This is because oil production in January at which oil output would be frozen was at a very high level. OPEC crude oil output in January totaled 31.92 million barrels per day (bpd), the highest since the cartel introduced its overall production quota of 30 million bpd at its 160th general meeting in December 2011, according to the International Energy Agency. January production in major oil producing countries such as Saudi Arabia, Iraq and Iran increased from the previous month. The agreement seeks to freeze output at the very high levels in January rather than cutting output from these levels. In Russia that joined the agreement, January’s production was as high as 11.22 bpd. As crude oil inventories have reached a record level with a supply surplus projected at 1.7 million bpd for the first half of this year, analysts doubt if the agreement to freeze oil output at the very high levels would contribute to reversing the overall supply-demand relationship.

The second problem is whether or how this agreement could be implemented. The four-country agreement conditions the freeze on other major oil producing countries’ cooperation in the freeze. The other major oil producing countries include Iran and Iraq. While Iraq is strongly willing to increase oil production, Iran is about to come back to the international oil market following Western countries’ decision to lift economic sanctions on Iran. Most market participants believe that Iran is unlikely to accept the agreement to freeze output at a January level before its comeback to the international market. In fact, Iran, though supporting the four countries’ freeze on any expansion from January levels, vowed not to accept the freeze for its production. Therefore, market participants have realized that the production freeze agreement has various problems. After the production freeze agreement led the WTI futures price to rise back above $30/bbl, the price has seesawed while falling on Saudi government officials’ remarks emphasizing that the agreement calls for freezing output at January levels instead of cutting it from these levels.

As noted above, the supply surplus on the world oil market is at a very high level at present. Even if the freeze agreement is implemented, the situation may not be reversed immediately. Depending on developments involving world economy risks and Iran’s comeback to the international oil market, downward pressure may arise on crude oil prices again. However, the latest agreement represented the initiative taken by Saudi Arabia and other major oil producing countries as the first step for their coordinated actions, exerting some impacts on the perceptions of market participants. Given a possible slower pace in Iran’s comeback to the international oil market than currently expected and the depletion of output at existing oil fields under investment shortages caused by the
oil price plunge, we may have to closely watch whether the freeze agreement would contribute to accelerate market rebalancing which is expected to start in the international oil market in or after the second half of this year.

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