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OPEC Agrees to Cut Production for the 1st Time in 8 Years

Ken Koyama, PhD
Chief Economist, Managing Director
The Institute of Energy Economics, Japan

On November 30, the Organization of the Petroleum Exporting Countries at its 171st ministerial conference agreed to reduce the 14 OPEC members' crude oil production by about 1.2 million barrels per day to 32.5 million bpd for six months from January 2017. This was the first OPEC production cut agreement in eight years since the oil cartel's agreement to reduce production by 4.2 million bpd at its 151st ministerial conference in December 2008.

The market responded to the OPEC production cut agreement, with crude oil prices rising substantially. On the New York market on the same day, the key West Texas Intermediate futures contract soared by $4.21 per barrel or 9.3% to $49.44/bbl, coming closer to the psychologically important level of $50/bbl. The key Brent futures increased by $4.09/bbl or 8.8% to $50.47/bbl, rising back above $50/bbl for the first time in almost one month.

Before the OPEC decision that indicated its great influence on the crude oil market anew, there were considerable twists and turns in talks between OPEC members. Tough coordination or negotiations lasted until just before the conference. After OPEC at its extraordinary meeting in Algeria in late September announced a surprise plan to cut production to a 32.50-33.00 million bpd range in a manner to successfully attract global attention, the oil cartel had difficulties in coordinating a proposal to fix country-by-country cuts to put the plan into action.

A particular problem, as is well known, was the confrontation between Iran willing to expand production beyond 4 million bpd after the termination of Western economic sanctions and Saudi Arabia giving priority to putting Iran into a production cut agreement. The two big Middle Eastern powers of Saudi Arabia and Iran have continued confrontation or strained relations for diplomatic and geopolitical reasons beyond oil production coordination. The fate of the OPEC conference was expected to depend on whether the two countries could reach a compromise. As major oil producing countries including the two continued tough negotiations and coordination until just before the conference, oil market players and experts were divided over whether OPEC could produce any production cut agreement. I had thought that the chance was 50/50 for OPEC to achieve any agreement.

Eventually, however, OPEC overcame the confrontation to reach the agreement. This was primarily because the oil producing countries shared a fear that if they fail to coordinate their opinions toward a successful agreement, crude oil prices would come under strong downward pressure and slip below $40/bbl. Plagued with economic deterioration amid prolonged crude oil

price weakness, they were commonly willing to avoid the worst situation where crude oil prices would fall below $40/bbl. They eventually found a foundation for their compromise.

Following the surprise OPEC decision in Algeria, Saudi Arabia's strategic policy shift played a great role in producing the production cut agreement. Amid the crude oil price plunge from the second half of 2014, Saudi Arabia had adopted a strategy of giving priority to maintaining its market share in view of massive expansion in U.S. shale oil production amid high oil prices and left market forces to fix prices even at the cost of further price declines. In the face of economic deterioration caused by weak oil prices, however, Saudi Arabia shifted to a policy of preventing further oil price declines as far as other oil producing countries accept a coordinated production cut (while refusing to single-handedly reduce production). In a bid to avoid excessively low oil prices and improve the supply-demand balance by reducing excessively accumulated oil inventories, Saudi Arabia and OPEC achieved the production cut agreement while winning cooperation from Russia and other non-OPEC oil producing countries.

In order to realize the agreement, OPEC adopted various ideas and compromises to set country-by-country production quotas. Nigeria and Libya plagued with security deterioration and other special conditions were put outside the production cut framework. Indonesia, which is a net oil importer, was also left outside the framework, with its OPEC membership suspended temporarily. As for Iran's production adjustment that was the biggest pending problem, OPEC compromised on a slight production increase of 90,000 bpd from the present level while setting Iran's production quota at 3.8 million bpd, lower than Iran's target of 4 million bpd. Iraq accepted a production cut of 210,000 bpd and a quota at 4.35 million bpd. Saudi Arabia, Kuwait and the United Arab Emirates accepted their central role in cutting production by accepting a total reduction of 760,000 bpd. Particularly, Saudi Arabia agreed to reduce production by about 500,000 bpd to 10.06 million bpd. However, it managed to keep its production above 10 million bpd. In this way, the OPEC agreement reflects various ideas and compromises.

As the market has responded to the OPEC production cut agreement, crude oil prices are expected to range mainly from $50/bbl to $55/bbl in the short term. The whole of the international oil market is gradually going in the direction of rebalancing toward 2017. If the OPEC production cut and cooperation from non-OPEC oil producing countries (planning to lower production by up to 600,000 bpd) are implemented successfully, the rebalancing may accelerate.

However, the situation may not be so simple. In the future, market players will pay attention to whether the production cut agreement could actually be implemented. While OPEC is set to hold full-fledged negotiations with non-OPEC oil producing countries, past developments lead many observers to question the effectiveness of Russia's cooperation in reducing oil production. Attention would have to be paid to Iranian and Iraqi production trends. In addition, production trends of Nigeria and Libya put outside the production cut framework will exert great influences on whether the OPEC agreement could be implemented. Eventually, there is no guarantee that OPEC production could be limited to 32.50 million bpd. Some observers expect OPEC output to total around 33 million bpd. Although the production cut agreement is important, compliance with the agreement could exert greater influences on the market than the agreement itself, as seen in the past.

Another matter of great interest is the impact of U.S. shale oil production. If crude oil prices exceed $50/bbl and chase higher ground, shale oil production may be revitalized. No matter if a substantial increase as seen until 2014 is realized again, any shale oil production expansion may greatly influence the supply and demand environment for the international oil market and, and at least an expectation for production expansion may influence market players' sentiment. While OPEC will try to underpin crude oil prices, the presence of shale oil will work to cap these prices. Given that crude oil prices tend to respond to shale oil production changes faster than to conventional oil output changes, we will have to closely watch U.S. shale oil production in 2017.

While the crude oil price trend has entered a new stage due to the OPEC production cut agreement, the market will remain sensitive to OPEC and non-OPEC oil producing countries' compliance with the production cut, the shale oil production trend and the speed of the rebalancing under their influences. We would like to pay attention to the future market trend.

Contact: report@tky.ieej.or.jp

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