Special Bulletin

A Japanese Perspective on the International Energy Landscape (316) March 24, 2017

Oil Producing Countries' Coordinated Production Cut Exposed to Market Pressure

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

Crude oil prices have been gradually falling. On March 23, the front-month futures contract on the West Texas Intermediate crude closed at $47.70 per barrel, down $0.34/bbl from the previous day. The key Brent crude futures contract also lost $0.08/bbl to $50.56/bbl, the lowest since last November 30.

After the Organization of the Petroleum Exporting Countries announced an agreement to cut production in a coordinated manner at its conference late last November, crude oil prices rose from less than $50 to a $50-55/bbl range. The key WTI futures price remained in the boxed range from early December to early March on a daily closing basis. Hopes on OPEC and non-OPEC oil producing countries' coordinated production cut supported the bottom of the range while concerns about high oil inventory levels and growing U.S. shale oil production kept downward pressure on the price at the ceiling. The price was stable within the narrow range.

In fact, however, a sign of a change in the trend emerged around late February. The WTI price started a downward trend after peaking at $54.45/bbl on February 23. The downward trend grew clearer since early March. From March 3, the WTI price continued falling for seven market days. On March 9, it fell to $49.28/bbl, slipping below $50/bbl for the first time in some three months. It slightly rebounded later but basically remained weak. From March 17, the key WTI futures price continued falling for three market days, slipping below $48/bbl. The key Brent futures price also declined to the level where possibility of below $50/bbl oil prices emerged.

What factors are behind the oil price decline? Usually, various factors compositely influence crude oil prices. For example, stock prices ended their upward trend since the Trump Rally in early March and weakened gradually, exerting some impact on crude oil prices. Market players have become skeptical of any steady upward trend for the U.S. economy and the world economy and begun to find factors of their concerns, leading to some impact on crude oil prices.

However, more direct influences on crude oil prices have come from oil supply and demand fundamentals. While OPEC and non-OPEC oil producing countries have implemented their coordinated production cut, global oil inventories have remained high. Particularly, U.S. crude oil inventories have basically continued increasing since early this year. Latest data indicate that private sector crude oil inventories reached a significantly high level. The inventory expansion runs counter to the needed correction of the inventory level cited by OPEC and non-OPEC oil producing countries as the goal for their coordinated production cut, working to exert downward pressure on crude oil prices. A more important factor behind the high inventory level is a greater-than-expected recovery in U.S. shale oil production.

We may have to take into account the Trump administration's policy support for U.S. shale oil production. At present, however, the support, though making some contribution to shale oil production, might have failed to exert any real impact on shale oil production. Rather, crude oil prices' recovery beyond $50/bbl on the coordinated production cut might have encouraged shale oil producers to expand output. A growing view is that U.S. shale oil producers might have successfully increased their business efficiency and cut costs for their survival during the weak oil price period that lasted for more than one and half years from the second half of 2014, becoming able to maintain and expand production more easily than earlier conceived at the present price levels. When I discussed crude oil and other energy problems with various experts in Europe two weeks ago and in Houston last week, I felt that they were growing more bullish and optimistic about U.S. shale oil production. In fact, U.S. crude oil production returned to a growth path in the fourth quarter of 2016 and increased by about 700,000 barrels per day in six months from the first week of last October.

What are the implications of the crude oil price trend and background factors for the trend? I feel that the market is prompting oil producing countries to take the next action by shaking them amid their coordinated production cut. The market is apparently questioning whether oil producing countries view their coordinated production cut since early this year as sufficient and how they will deal with the coordinated action in the future.

As indicated by various data sources, OPEC has complied with the production reduction target more than expected. According to the International Energy Agency, the rate of compliance with the target for OPEC came to 105% in January, meaning that the OPEC production cut in the month was 5% larger than the target. The rate, though falling slightly, was still as high as 91% in February. Nevertheless, crude oil prices indicated their downward trend. The market might have demonstrated to oil producing countries that the present production cut is not enough to produce effects including an oil inventory decline. Complicating the problem is the fact that OPEC's high rate of compliance with the production reduction target is attributable to Saudi Arabia's substantial production reduction. The average rate of compliance with the target for Saudi Arabia in January and February stood at 138%, the highest among OPEC members. Such rates for other OPEC members ranged wide, indicating that the OPEC members are not necessarily united to comply with the coordinated production cut.

This point is clear when we turn our eyes to non-OPEC oil producing countries. Russia's crude oil production, though falling by 100,000 bpd from December, is as high as 11.48 million bpd, according to the IEA. Under such situation, the market has generated downward pressure on crude oil prices. The coordinated production cut is planned to end in six months from the beginning of this year. Oil producing countries indicated that the six-month coordinated production cut would be sufficient. Apparently, they had a strategy of promoting oil inventory reduction with the six-month production cut to buy time until the market goes in the direction of full rebalancing. However, the present market environment is greatly shaking the strategy.

The market may be asking oil producing countries if they plan to continue the coordinated production cut until the end of this year instead of ending it in six months, how they would improve their wide-ranging rates of compliance with the production cut target, and what may be a specific production cut target if the coordinated cut is continued into the second half of this year. Depending on answers or responses to these questions from oil producing countries, particularly Saudi Arabia, crude oil prices may fluctuate greatly. In a run-up to the next OPEC conference in late May, the trends of the market and oil producing countries will attract attention.

Contact: report@tky.ieej.or.jp
The back issues are available at the following URL
http://eneken.ieej.or.jp/en/special_bulletin.html