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June OPEC Output Rose by 340,000 bpd Indicating Change in Compliance with Production Cut

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The Organization of the Petroleum Exporting Countries struck a production cut agreement at its meeting last November and implemented a coordinated production cut covering OPEC and non-OPEC oil producing countries including Russia from January this year. Until May, OPEC as a whole continued its compliance with the production cut under higher discipline than expected. In June, however, the OPEC rate of compliance with the production cut declined remarkably, attracting global attention.

The International Energy Agency's latest monthly Oil Market Report (July 2017 issue) stated that the 14 OPEC member countries, including Equatorial Guinea that joined the oil cartel at an OPEC meeting May this year, expanded crude oil production in June by 340,000 barrels per day (bpd) from the previous month to 32.6 million bpd. Particularly remarkable country-by-country increases included 130,000 bpd for Saudi Arabia, 80,000 bpd for Libya and 60,000 bpd each for Nigeria and Angola. The four countries' combined oil production expansion loosely amounted to the increase for the whole of OPEC.

For the production cut agreement at last November's OPEC ministerial conference, please refer to the 300th issue of the Special Bulletin on A Japanese Perspective on the International Energy Landscape. The agreement primarily called for (1) limiting oil production to 32.5 million bpd between January and June 2017 for the OPEC countries other than Equatorial Guinea that had not joined the oil cartel then, (2) setting country-by-country production cut targets to secure the effectiveness of the cut and reduce production by a total of about 1.2 million bpd from the reference production level, and (3) exempting Libya and Nigeria in special situations from the coordinated cut.

Then, any failure to strike the oil production cut agreement was feared to lead to the worst scenario where oil prices would plunge again. To avoid the worst scenario, OPEC apparently considered various ideas and compromises to produce and implement the agreement. Given that the oil production cut to prevent any more fall in prices was a top, urgent priority, OPEC steadily maintained its policy of implementing the agreed production cut accurately from January. In fact, the OPEC production cut compliance rate remained close to 100% between January and May, exceeding 100% occasionally. This means that OPEC reduced production by more than the agreed level of about 1.2 billion bpd. While the production cut compliance rate for the whole of OPEC remained close to 100%, country-by-country compliance rates varied. While many OPEC countries failed to comply with their respective production cuts, OPEC leader Saudi Arabia implemented a greater cut than agreed to keep discipline for the whole of OPEC.

However, the OPEC production cut compliance rate sharply fell to 78% in June. The rate, though being not necessarily low, represented a decline of nearly 20 percentage points from the previous month. As noted above, Saudi Arabia scored a large increase in June oil production. It is explained that Saudi Arabia must respond to a summer increase in domestic demand for oil for power generation while maintaining exports. Saudi Arabia’s compliance rate in June was 102%, indicating that it was fully complying with the coordinated production cut. Given that Saudi Arabia’s substantial production cut held the key to the entire OPEC’s compliance with the coordinated cut, however, relevant future developments may attract much attention.

In addition to the four member countries as mentioned above, Iran and Iraq also increased production in June. As the two countries have been seen as holding the key to OPEC’s compliance with the coordinated production cut, their future production trends will be significant. There may be various factors behind the production expansion. One apparent factor is that they have to expand production to maintain or increase oil revenues amid the prolonged weakness of oil prices, even if the expansion contradicts any policy seeking to raise prices. As Libya and Nigeria exempted from the coordinated production cut are increasing production, there may be an incentive among other OPEC countries to maintain their market shares and secure oil revenues.

Such situation may represent a difficult kind of dilemma for OPEC. While keeping its production cut compliance rate close to 100%, OPEC has fallen short of achieving its target of lowering oil inventories to appropriate levels. A factor behind the shortfall is U.S. shale oil that has enhanced its resistance to low oil prices. As a result, benchmark oil prices have basically remained below $50 per barrel since June. The trend may represent the market’s messages to OPEC saying that a planned end to the coordination production in June could lead to a plunge in oil prices and that the present production cut level is not necessarily sufficient.

It is significant that the sign of elusion in OPEC’s compliance with the coordinated production cut has emerged at this timing. There may be no problem if the compliance rate drop ends up as a one-off event. If the rate declines gradually in the future, however, the oil market may weaken again. If a decline in the compliance is sustained, OPEC-expected rebalancing (the elimination of an oil glut or the supply-demand equilibrium) in the international oil market may be postponed further (as far as other conditions remain unchanged).

In the history of the international oil market, OPEC’s rate of compliance with any coordinated production cut tended to start at high levels and gradually decline. For OPEC as a group of sovereign states, compliance with a coordinated production cut has always been a difficult problem. Any OPEC country always has an incentive to secure or maintain oil revenues by increasing production even slightly while the other OPEC members comply with a coordinated production cut to defend oil prices. Any mechanism to completely prevent such free ride has not been found. The fear of further oil price falls (and their economic effects) is the most effective factor for OPEC countries to enhance their cooperation and collaboration, as indicated by the past history.

U.S. shale oil, though attracting global attention at present, is a price taker that moves in accordance with crude oil price levels. Close watch must be kept on OPEC and its leader Saudi Arabia as a market maker that tries to exert influences on the market by adjusting the supply-demand balance with strategic intentions or purposes.

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