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OPEC/Non-OPEC Coordinated Production Cut Extended until 2018-end

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On November 30, the Organization of the Petroleum Exporting Countries held the 173rd Meeting of the OPEC Conference in the Austrian capital of Vienna to discuss a future international oil market outlook and its production adjustment policy. Russia, Oman, Mexico and other non-OPEC oil producing countries participating in the coordinated production cut since January 2017 held a joint meeting with OPEC on the occasion of the ordinary OPEC meeting, agreeing to extend the present coordinated production cut (1.76 million barrels per day comprising 1.2 million bpd for OPEC and 560,000 bpd for non-OPEC oil producing countries) for nine months until the end of 2018. The Declaration of Cooperation, issued after the meeting, included their pledge to extend the coordinated production cut for nine months and urged the participating countries to comply with the coordinated production cut anew. Given various uncertainties regarding the international oil market, it also said the OPEC and non-OPEC oil producing countries will meet in June 2018 to review the production cut in line with the market conditions and progress toward rebalancing or the normalization of oil inventories.

In response to the OPEC and non-OPEC decision to extend the coordinated production cut, crude oil prices rose slightly. The front-month futures price closed the day $0.46 per barrel higher at $63.57/bbl for Brent and $0.10/bbl higher at $57.40/bbl for West Texas Intermediate. The extension of the coordinated production cut had been well anticipated by most market players and discounted into the market. The slight increase in crude oil prices came as the decision extended the coordinated production cut until the end of 2018 and was interpreted by market players as setting present production levels as effective production quotas for Libya and Nigeria that have been left out of the coordinated production cut due to their geopolitical risks.

The OPEC and non-OPEC coordinated production cut is thus set to last for a little more than one year from now. The production cut from January 2017 has successfully worked to reduce oil inventories. While private sector oil inventories in the members of the Organization for Economic

Cooperation and Development are still close to 3 billion barrels, exceeding the average for the past five years, they steadily and slowly decreased from January to September this year, according to a monthly report by the International Energy Agency. While global oil demand in 2017 increases by 1.5 million barrels per day from the previous year, non-OPEC oil production growth including U.S. shale oil production expansion is limited to 700,000 bpd. The limited non-OPEC production growth has been combined with the OPEC-led production cut to bring about the inventory decline.

Quarterly supply and demand in the international oil market indicated a substantial excess supply until the fourth quarter of 2016, a supply-demand equilibrium in the first quarter of 2017, an excess demand of 800,000 bpd in the second quarter and an excess demand of 200,000 bpd in the third and fourth quarters, paving the way for inventories to decline in the whole of 2017. In response to such supply and demand conditions, crude oil prices have grown sensitive to geopolitical risks. Since October, crude oil prices have risen in response to developments involving the Kurdish problems in Iraq and the reported arrest and detention of many royal family and cabinet members in Saudi Arabia. In late October, Brent rose back above $60/bbl for the first time in 27 months.

The present crude oil price ranges including the $60-65/bbl range for Brent and the $55-60/bbl range for WTI have resulted from fundamental factors, supply-demand balance changes toward rebalancing and the OPEC and non-OPEC coordinated production cut behind the changes. Therefore, the Vienna OPEC and non-OPEC meeting to determine the future direction of the coordinated production cut had attracted global attention.

In this sense, the decision to extend the coordinated production cut had been well anticipated, providing no “surprise” for market participants. Therefore, market responses were limited to the slight crude oil price rise. For the immediate future, crude oil prices are unlikely to change sharply in response to the latest OPEC and non-OPEC decision. Unless unexpected geopolitical risks or subsequent oil supply disruptions arise, crude oil prices may remain around the present levels while fluctuating in response to supply and demand changes and news about these changes. However, there are key factors that could determine the direction of future crude oil prices.

The first important factor is U.S. shale oil production that uniquely responds in a relatively short term to crude oil price changes. Crude oil price levels since late October are likely to stimulate shale oil production. Since November, the number of operating U.S. oil-drilling rigs has been increasing. Given a time lag of some three months or more, shale oil production expansion could accelerate from the first quarter of next year. My analysis indicates that the international oil market may see an excess supply again in the first half of next year if OPEC production remains unchanged.

In the first quarter of next year, particularly, excess supply could be large. Shale oil production expansion could then accelerate in that period, exerting downward pressure on crude oil prices.

Second important factors influencing the oil supply-demand balance include world economy trends and oil demand, and non-OPEC oil production other than U.S. shale oil. The world economy is expected to grow by around 3.7% in 2018 and now indicates brisk trends including global stock market hikes. Given concerns about bubbly stock prices and U.S. interest rate hikes, however, we must closely watch world economy trends. On the contrary, however, if oil demand mainly in emerging countries increases at a faster-than-expected pace, the tightening of the supply-demand balance or rebalancing may accelerate. On the supply side, non-OPEC oil production other than U.S. shale oil has been stagnating or decreasing. The present price levels still fall short of stimulating sufficient investment in oil development. If unexpected supply disruptions arise in such situation, the supply-demand balance may tighten.

Given such various uncertainties, OPEC agreed with Russia and other non-OPEC oil producing countries to extend their coordinated production cut and intermediately review the market at their meeting next June. If the normalization of oil inventories comes into sight amid smooth rebalancing, they may have to discuss their exit strategy including when and how to end the coordinated production cut. However, any exit strategy would be difficult to draft. If an exit from the coordinated production cut fails to be timely and appropriate, the market may be exposed to disappointment selling. If shale oil production expansion impedes rebalancing and exerts downward pressure on crude oil prices, however, the OPEC and non-OPEC oil producing countries may have to consider reaffirming their compliance with the coordination production cut or enhancing the cut. The history of the international oil market indicates that oil producing countries' compliance with their coordinated production cut declines gradually as time passes. In this sense, oil producing countries could be plagued with new difficulties.

While crude oil prices are expected to remain at about the current price range in the immediate future as a result of the latest OPEC and non-OPEC decision to extend the coordinated production cut, the international oil market faces various uncertainties and turbulent factors that could lead to crude oil price volatilities. We will have to closely watch future market developments and policy trends in oil producing countries.

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