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As Unraveling of Oil Production Cut Arrangement Indicated Price War, Oil Prices Recorded Historic Falls

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Crude oil prices took steep falls on the international market as the week opened. On March 9, the front-month futures contract on the West Texas Intermediate crude oil closed at $31.13 per barrel with a heavy loss of $10.15/bbl from the previous trading day. The key Brent futures price also recorded a sharp fall of $10.91/bbl to $34.36/bbl. The WTI price's intraday low on the day slipped far below $30/bbl to $27.34/bbl. The single-day percentage drop of 25% on a closing price basis (more than 30% for the intraday low) was the sharpest since a plunge after the start of the Persian Gulf War in January 1991, representing a historic fall.

The historic fall came as the market entered a price war due to the unraveling of the OPEC-plus oil production cut arrangement including the Organization of the Petroleum Exporting Countries and some non-OPEC oil-producing countries such as Russia. In the 470th issue of "A Japanese Perspective on the International Energy Landscape," I explained that OPEC at its meeting on March 5 agreed to "recommend" the OPEC-plus group to maintain the current joint production cuts until the end of this year and implement additional cuts totaling 1.5 million barrels per day until the end of 2020. At an OPEC-plus meeting on March 6, however, Russia refused to participate in the joint production cuts, leading the OPEC-plus arrangement to unravel. This triggered perception that Saudi Arabia would expand its oil production from the current level of 9.7 million bpd to more than 10 million bpd in April after taking the leadership in the joint production cuts and OPEC's coordination with Russia, leading market players to expect a price war.

In the international oil market that has seen oversupply since early 2020, growing global economic slowdown risks amid the expanding new coronavirus pandemic have exerted strong downward pressure on crude oil prices. In its latest outlook released on March 9, the International Energy Agency forecast that global oil demand would decline by 0.09 million bpd in 2020. Only one month after its February outlook predicted an increase of 0.83 million bpd, the IEA substantially lowered its oil demand projection for 2020 and forecast that global oil demand would fall for the first time since 2009 amid the global financial crisis as the expanding new coronavirus pandemic decelerates the global economy. In such circumstance, crude oil prices took sharp drops close to free falls on speculation that the market would enter a price war on the unraveling of the OPEC-plus joint production cut arrangement that had supported oil prices.

Crude oil price falls seriously affect any oil-producing economy. To avoid oil price falls, oil-producing countries have taken initiatives to cut or adjust production, as seen historically. The current joint oil production cut initiative has been taken since oil-producing countries were affected by the WTI price's fall below $27/bbl in February 2016. Why has the joint production cut arrangement unraveled in a manner to induce a price war?

Russia directly triggered the unraveling by refusing to participate in the joint production cuts at OPEC-plus negotiations. A reported factor behind the refusal is that Russia depends less on oil revenues than OPEC countries. Another reported factor is that Russia has increased oil production while nominally participating in the joint production cuts. From my viewpoint, however, the largest factor may be Russia's strategic conclusion that the continuation and enhancement of production cuts to support oil prices would eventually benefit U.S. shale oil to the disadvantage of Russia's national interests. At a time when Russia remains under Western economic sanctions and sees worsening relations with the United States that has expanded its power through its "energy dominance" resulting from the shale revolution, Russia might have judged that its production cut to support oil prices would back up the expansion of U.S. shale oil production to the advantage of the United States.

Under such strategic judgment, the maintenance and enhancement of the joint production cuts have not been acceptable for Russia, despite persuasion by Saudi Arabia or OPEC. Coming next is Saudi Arabia's strategic judgment. Saudi Arabia, though featuring the world's lowest oil production costs, depends heavily on oil revenues. Crude oil prices required to cover massive fiscal spending and avoid any budget deficit are high. Oil revenues are important for upgrading and diversifying the Saudi economy under the Saudi Vision 2030 initiated by Crown Prince Mohammed bin Salman. It is significant for Saudi Arabia to secure a certain oil price level to make a success of Saudi Aramco's initial public offering positioned as the crown jewel of Saudi reform. Therefore, oil production adjustments to meet supply and demand fundamentals have been very important.

Learning lessons from its bitter experience in the first half of the 1980s, however, Saudi Arabia has basically pursued joint production cuts with other oil-producing countries without serving as a swing producer to independently adjust production. The OPEC-plus joint production cut arrangement has met the basic Saudi policy.

As the joint production cut arrangement has unraveled due to Russia's refusal to take part in the cuts, Saudi Arabia has had two options: to continue behind-the-scenes negotiations with Russia in pursuit of the joint production cuts or to change its policy to go in the direction of a price war. The latter option would be painstaking for the Saudi economy and cannot be chosen without considerable preparedness or determination. Actually, however, Saudi Arabia demonstrated its strong preparedness and determination to the market by indicating an oil production expansion from April, paving the way for a price war.

Market participants have provided various views about factors behind the grave Saudi policy change. One said that Saudi Arabia might have given priority to pursuing a market share suitable for itself to counter the United States and Russia as crude oil prices decline in the wake of the unraveling of the joint production cut arrangement. This choice is close to the market recapturing strategy through net-back pricing that Saudi Arabia adopted from the end of 1985.

Such view may apparently be adequate. However, my view is that Saudi Arabia intends to tolerate sharp oil price falls once in view of discord among oil-producing countries, check U.S. shale oil production expansion, share the negative effects of weak oil prices and the significance of joint production cuts with other oil-producing countries and reconstruct the joint production cut arrangement. As a matter of course, it would be difficult and painstaking to reconstruct the arrangement. Some time would be required for the reconstruction. The more time is required and the more heavily oil prices fall, the more painstaking the reconstruction would be. Nevertheless, Saudi Arabia might have chosen to lose a battle to win a war or adopted a shock therapy.

The oil market experienced oil price plunges on developments regarding the failure of Saudi Arabia’s production adjustment function in the past. Such developments included the policy change in late 1985, a decision to increase oil production at an OPEC meeting in Jakarta in 1998 and a policy of tolerating oil price falls in the second half of 2014. In the future international oil market, we will have to pay attention to the expansion of the new coronavirus pandemic and its impacts on the global economy, how far oil prices would fall, how oil price falls would affect U.S. shale oil production and how OPEC and Russian oil policies would change.

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