

COMMENTARY

OPEC Production and the Falling Price of Oil

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What does the apparent lack of a price response to an OPEC production quota cut tell us about the current market and what can we expect going forward?

On Friday, October 24, the 13 members of the Organization of Petroleum Exporting Countries (OPEC) announced their decision to cut production by 1.5 million barrels a day effective November 1, 2008 (11 of the 13 members are slated to participate in the reduction). OPEC's stated purpose for the cut is to reduce the oversupply of oil in global markets and stem the free fall in oil prices (prices are currently some 57 percent lower than in July of this year). OPEC's decision was not taken lightly, as members are also fearful of contributing to a more catastrophic decline in global economic activity that would likely suppress oil demand for years to come.

Substantially revised projections of global economic growth, and consequently oil consumption, when coupled with current oil output have combined to create the prospect of a growing oil surplus. Recent projections on the need for OPEC crude for the next two calendar quarters suggest a "call" on OPEC in the range of 30.4 to 31 million barrels per day (mmb/d), yet OPEC's September output is estimated to have been above 32.2 mmb/d, so the 1.5 mmb/d target reduction was not unexpected. Despite the OPEC announcement, however, prices have continued to fall, indicating a high degree of skepticism that either the cut will be sufficient to stem the decline or that OPEC members' discipline in meeting the reduction targets can be assured.

The current decline in oil prices has been attributed to several factors. Perceptions of the strength and longevity of these trends clearly impacted the OPEC decision and will in large part determine how oil markets fare in the future. These include:

Global Energy Demand

Energy demand estimates have fallen precipitously over the past several months. The downward revisions initially reflected a demand response to record-high oil prices, mostly in the United States and Europe, but now global energy demand estimates have been reduced further as a result of the expected slowdown in global economic growth across the board. Gross domestic product (GDP) growth estimates are down around 2 percent from even recent estimates as the financial crisis spreads and worsens. Estimates for incremental growth in global oil demand for next year now range from 0 to 3/4 of 1 percent—far below estimates made at the beginning of this year.

Though forecasts point to overall weakening oil demand as a result of stunted global economic growth generally, demand continues to be influenced by a number of other factors as well. For example, as a consequence of the seasonality of consumption patterns in the Organisation for Economic Co-operation and Development (OECD) countries, oil demand typically drops between the fourth and second quarters of the year. And although we have already seen a marked reduction in U.S. petroleum demand over the past year (mainly due to higher prices), the impact of the economic downturn for developing/emerging economies, like China, remains unclear, particularly as we try to accurately forecast China's demand in the aftermath of the Olympic games and global economic slowdown.

Financial Market Volatility

The uncertainty and volatility surrounding global financial markets and the stabilization of the value of the dollar are also factors that affect global oil markets, as are choices that investors make as they seek to find "safe havens" in which to park capital. Until global financial markets settle down, it is very likely that oil prices will continue to fluctuate with swings in the larger markets.

OPEC Quota Discipline

OPEC countries bound by quota targets (Iraq, for example, currently has no quota obligation) are currently producing nearly 300,000 barrels above the 28.8 mmb/d quota. Therefore, adherence to the 1.5 mmb/d quota cut would have to yield nearly a 1.8 mmb/d production cut. Historically, “quota discipline” is difficult to achieve during times of rapid price declines. OPEC member countries have decidedly different production costs and budgetary requirements. Consequently, production decisions that affect a nation’s oil revenues are complicated and highly individualized. If oil price declines produce significant adverse impacts on internal budgets, producers are, at times, inclined to sell additional barrels into the market (albeit at lower prices) to try and make up the budget gap. To the extent that these additional barrels further exacerbate the real or perceived surplus, the intended impact of the OPEC production cut is likely to be undermined.

Non-OPEC Supply

OPEC also called on non-OPEC suppliers like Russia and Mexico to join them in reducing global oil production in order to bring the market into better balance and stem the current decline in oil prices. Non-OPEC suppliers have struggled in recent years to maintain and increase production levels despite record-high oil prices. In the wake of higher oil prices, many suppliers have advanced projects to produce more unconventional (and higher priced) resources and biofuels. Consequently, a fear going forward is that oil prices may drop well below the cost of developing these resources and limit the volume of new (and needed) supplies in the longer term. In the near term, however, non-OPEC suppliers face the same difficulty deciding to cut production in a time of declining prices as OPEC suppliers.

What to Expect

It is important to remember that all these projections reflect the current environment of extreme economic uncertainty. The scope and duration of the current global financial crisis is highly uncertain, as is its impact on longer-term economic growth and energy demand. If prices continue to erode, OPEC can be expected to continue to press for additional production cuts. The next OPEC meeting is scheduled for December 17, but the organization will continue to monitor the situation and has reserved the option to meet again if further action is required.

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