OPEC says, "Don't Count on Us" for More Supply

Posted by Gail the Actuary on December 19, 2011 - 7:34am
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The results of OPEC's latest meeting to set oil production quotas were announced this morning. Instead of production targets for individual countries, a group production ceiling of 30 million barrels a day was set. This amount is a bit less than OPEC produced in November 2011 (actual 30.367 mbd), according to its reckoning, and less than it would have produced most of 2011, if Libyan production had stayed on line, based on the amounts shown in its November Oil Market Report.

A recent history of oil production from the November Oil Market Report, both for OPEC and in total, is shown in Figure 1.

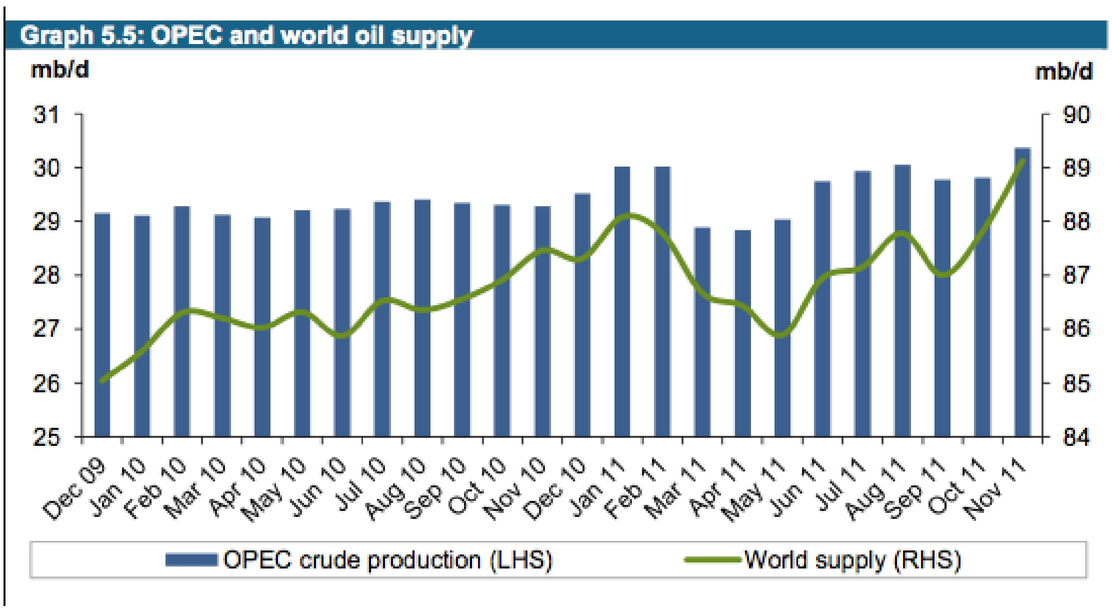

Figure 1. Recent oil production for World and for OPEC, according to OPEC November Oil Market Report.

According to a Platts report of the meeting, Venezuelan Oil Minister Rafael Ramirez told reporters, "We are going to reduce the level of production of each country to make space for Libya." That is not what people want to hear–Brent oil price is still over $100 barrel, even with what seems to be record production for both the world and OPEC, based on Figure 1.

The same Platts report also says, "OPEC on Tuesday said it expected demand for OPEC crude next year to average 30.09 million b/d." Thus, the new production cap is slightly less than what OPEC sees as demand going forward.

It should be noted that the new limit includes Iraq in addition to the “regular” OPEC countries. Thus, the agreement says that if Iraq increases its production, other OPEC countries will reduce their production to keep total production to 30 million barrels a day.

All of this comes shortly after Saudi Arabia announced that it has halted plans to increase capacity to 15 million barrels a day by 2020. I wrote about this in a recent post. Saudi Arabia claims to have 12 million barrels a day in capacity now, but there is little evidence that it can actually produce this amount of oil. Saudi Arabia recently boasted that it would increase oil production above 10 million barrels a day, to help offset the drop in Libyan oil production, but amounts reported by the OPEC Oil Market Report and the EIA report of monthly oil production are still under this amount. The highest Saudi oil production reported by the EIA is 9.94 million barrels a day in August 2011.

There would seem to be several reasons for applying an overall cap to OPEC production:

1. OPEC needs/wants high oil prices. They certainly don’t want the price of oil to fall by very much, if they are to have enough funds to pay for all their social programs. So holding production down is in their best interests. An overall cap provides as direct a way as possible of keeping overall production down.

2. It is not clear that most OPEC members have any spare capacity. Saudi Arabia may, in fact, need to “rest” its wells after pushing production to its recent high of 9.94 million barrels a day in oil production. Writing the agreement as an overall cap gives Saudi Arabia “cover” for resting its wells, as needed.

3. This approach is at least theoretically easier to administer. One or two or three countries can make a change in production, if desired, to bring total oil production down to the desired level, if others raise their production.

4. This approach gives a framework for future agreements that can be helpful if Iraq’s oil production should actually increase by very much. Iraq’s production is in effect pulled back in under the agreement.

5. This approach provides great “cover” if one or more OPEC countries experiences a decline in oil production. There is no need for embarrassment if an individual country should experience declining production, since a country can simply blame the result on a need to keep overall production within the selected limit, and thus “save face”. A country with very high stated reserves might be especially embarrassed by an unexplained decline in production, since this might also suggest that the stated reserves were inaccurate.

Why the Market Discounts the New Cap

I am aware that the price of oil dropped after the announcement of the new 30 million barrel a day cap. The view underlying this decline is that the new cap is similar to the individual country caps, and likely to be exceeded if circumstances are right. Furthermore, the 30 million barrel a day cap is similar to what OPEC has recently been producing, so there is no expectation of a cut in production at this time.

It seems to me, though, that OPEC is gradually changing from an association whose primary purpose is to hold down production, to an association of mostly aging oil countries who need to cover up the fact that their oil production may not be able to keep up much longer. The new methodology works much better, if part of the purpose is to cover up the reason for declining production of a few countries.

Figure 2 is a graph I showed in a recent post. It shows Middle Eastern and North African (MENA) oil production as a percentage of world oil production.

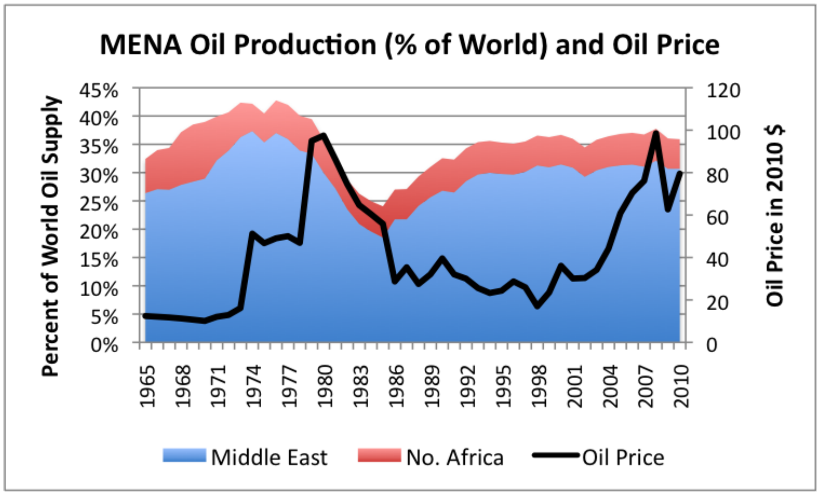

Figure 2. Middle East and North Africa oil production as percentage of world total, plus oil price in 2010 dollars. Amounts from BP Statistical Report. Oil includes NGL. Oil price comparable to Brent.

The countries included in MENA are not the same as OPEC, but there is a large overlap with the older OPEC members. Figure 2 shows that this group has not raised production relative to world production by very much, even when oil prices were high, suggesting that they have little capacity to do so.

As the very old wells in MENA countries age further, declining production can be expected to be an increasing problem, adding to the need for countries to "save face" as production declines, as mentioned in Point 5 above.

Conclusion

It will take a while to see how the new cap works out in practice. The important effect may not be in the next three months, but over the longer term, especially if Iraq's production increases.

Both EIA and IEA are expecting that OPEC will provide the majority of future increases in world oil production. If my interpretation is right, OPEC is suggesting that they will decide how much, if any, increase in production will be allowed through to the rest of the world–that is, assuming that the increase in OPEC production is really there in the first place, and not offset by other OPEC declines.

My expectation is that oil price will really depend on how well the world economy is doing. The world economy is threatening to slip into recession now. If it does, prices may go down. If it does not, and OPEC indeed keeps its production capped at 30 million barrels a day, we should expect higher oil prices ahead.

In any new agreement, the real question is how the agreement is administered in practice. I have suggested one way the new agreement may be used. It will be interesting to see what actually happens.

This post originally appeared on Our Finite World.