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To Cut or not to Cut: The Dilemma Facing OPEC

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1. Introduction

One of the many uncertainties engulfing the oil market nowadays is how will OPEC respond to the current slide in oil prices which saw the WTI price decline sharply by more than 45 percent from its peak in less than three months. The current slide in oil prices has created a sense of urgency within OPEC. OPEC called for an extraordinary meeting to be held on 18th November, 2008 but with the continuous downward pressure on oil prices the organization decided to bring the extraordinary meeting forward to 24th October, 2008. Its purpose is to discuss "the global financial crisis, the world economic slowdown and the impact on the oil market."

As is often the case, in the weeks before OPEC meetings many analysts offer their views on whether the organization will cut output, the size of the output cut and whether members have the power and possess the discipline to defend oil prices in current circumstances. Interestingly, many oil ministers and OPEC officials also join the debate and the media hype which very often adds to the confusion and dilutes the signal that OPEC wishes to send to markets by voicing very different views. For instance, Qatar's Oil Minister Abdullah al-Attiyah expected OPEC to cut oil production by one million barrels per day (bpd) or even more. Iran's OPEC governor Mohammad Ali Khatibi wants OPEC to cut output by 1 to 3 million bpd. The OPEC President and Algerian Oil Minister Chakib Khelil even proposed an "ideal" price range between $70 and $90 a barrel that OPEC would like to defend. This statement is quite surprising especially as it comes from someone who only few months ago predicted that oil prices would reach $200 per barrel by the end of this year.

Regardless of whether OPEC decides to cut output or not, the announcement is likely to have a limited impact on oil prices in the short run. In fact, the oil price (which has risen slightly in the last week) may have already discounted OPEC's anticipated next move. One major feature of the current oil markets is that prices have entered into a phase of indeterminacy where markets participants, including oil companies and oil producers, don't know where to anchor the oil price that balances supply and demand in the long run. This is affecting the behaviour of short term oil prices as long-run prices and short term oil prices seem to be co-determined. This has become apparent from the recent movement of oil prices when both the short term and long term oil price (i.e. the oil price for future delivery) increased and declined simultaneously. In such a market, traders tend to coordinate actions based on public signals. Even if news does not convey any useful information about the fundamentals of the oil market, it may propagate signals that help coordinate market expectations causing oil prices to overreact in either direction. There is an abundance of news and information which suggest that it is difficult for traders to coordinate their actions. However, traders limit their attention to a few signals that they think other market participants will also view as relevant in determining oil price movements. This explains why the market tends to look at one set of information at a time. In the past few months, traders based their decisions on news about inventories, potential supply disruptions, and the weak dollar. The situation has changed now and the market has switched to coordinating on public signals about the health of the world economy. In these current circumstances, OPEC signals about output cuts are likely to be washed out by news about the depth of the recession, the decoupling of Asian economies, and the impact that these have on global oil demand.

This does not mean that OPEC is irrelevant in the current context. On the contrary, since the early 1970s, OPEC has been central to understanding the dynamics of oil prices. With the shift to the futures market for oil price determination, OPEC has also become important in understanding the changes in the shape of the futures curve and expectations about changes in long term oil prices. At this critical juncture, it is important to assess OPEC actions during the last cycle as events in the past three years or so highlight some interesting features of OPEC behaviour. These observations help us identify the channels through which OPEC interacts with the market and understand how OPEC is likely to react to the current slide in oil prices.

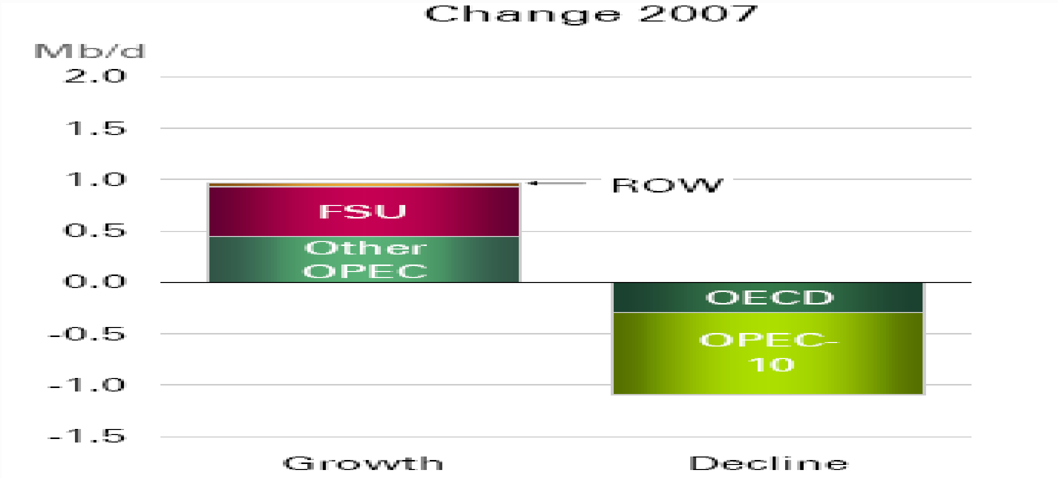
2. The Context of the Emergency Meeting: Active-Passive-Active OPEC

The latest cycle has raised various hypotheses about OPEC behaviour. Some argue that OPEC has realised that higher oil prices did not have adverse effects on the growth of the global economy and/or inflation and that oil demand is more price inelastic than they originally thought. In other words, OPEC learned, over time, that it can increase its share of the oil rent without undermining the market for its key commodity. The world economy has proven more resilient to high oil prices than the organization previously thought. More sceptical observers argue that OPEC is not concerned about the long term effects on global oil demand given that there is no sign of urgent or serious political/economic responses by OECD countries and that the climate change agenda is unlikely to seriously undermine demand for oil in the absence of alternative transport fuels. Others have noted that OPEC is concerned about high oil prices but that influencing oil prices is beyond OPEC’s power especially since the market perceives that OPEC’s spare capacity is less than the figure announced and not of the right quality. Others argued that OPEC is concerned about high oil prices and has the ability to influence the oil price but is politically constrained as actions to reduce the price of oil by any of the members are likely to be met with criticisms from the local population and other member countries. There are also fears that any action taken by OPEC may induce a downward spiral of oil prices which the Organization may not be able to control.

OPEC’s formal position during the boom has always been that the Organization is willing to increase output in response to customers' demand at current international prices. In other words, OPEC has been playing a passive role. It has been reluctant to reduce oil prices by auctioning part of the available spare capacity or to engage in heavy discounting of its heavy crude oil. Many intentionally or unintentionally fail to recognize that achieving market stability by supplying additional oil in case of physical disruptions and achieving lower oil prices are two different objectives and that OPEC is committed only to the former.

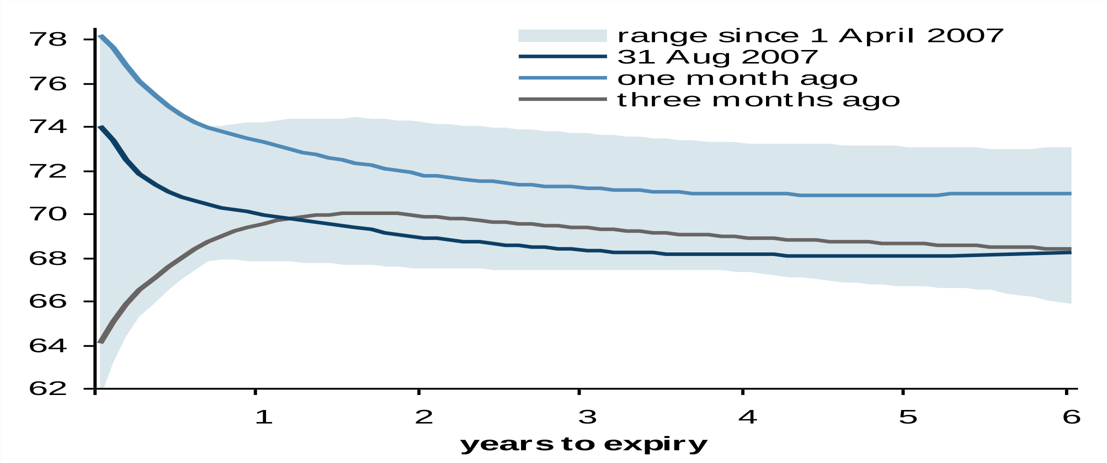
Although OPEC has been passive regarding oil price levels, it has been active in controlling the level of stocks. Rapid accumulation of crude oil stocks is not desired by OPEC. The Organization fears sharp oil price declines if physical traders decide to unwind their position and flood the market with supplies. In response, OPEC has shown willingness to adjust its supplies and in the process absorb part of the rise in inventories, cause spot prices to increase and change the shape of the futures curve. The data for 2007 suggest this kind of OPEC behaviour. In face of what OPEC considered to be a rapid accumulation of stocks, it engaged in excessive output cuts. Although in 2007 growth in global oil demand was positive, the growth of oil supply was negative mainly induced by reduction in OPEC output (see Figure 1). This meant that oil importing countries had to tap into their oil stocks reducing the level of crude oil inventories. As figure 2 below shows, the reduction in inventories changed the shape of the futures curve from contango into backwardation and resulted in the decline of inventories.

Figure 1: Change in oil Supply in 2007



Source: BP

Figure 2: Change in the Shape of the Futures curve from Contango (at front end of the Curve) to backwardation

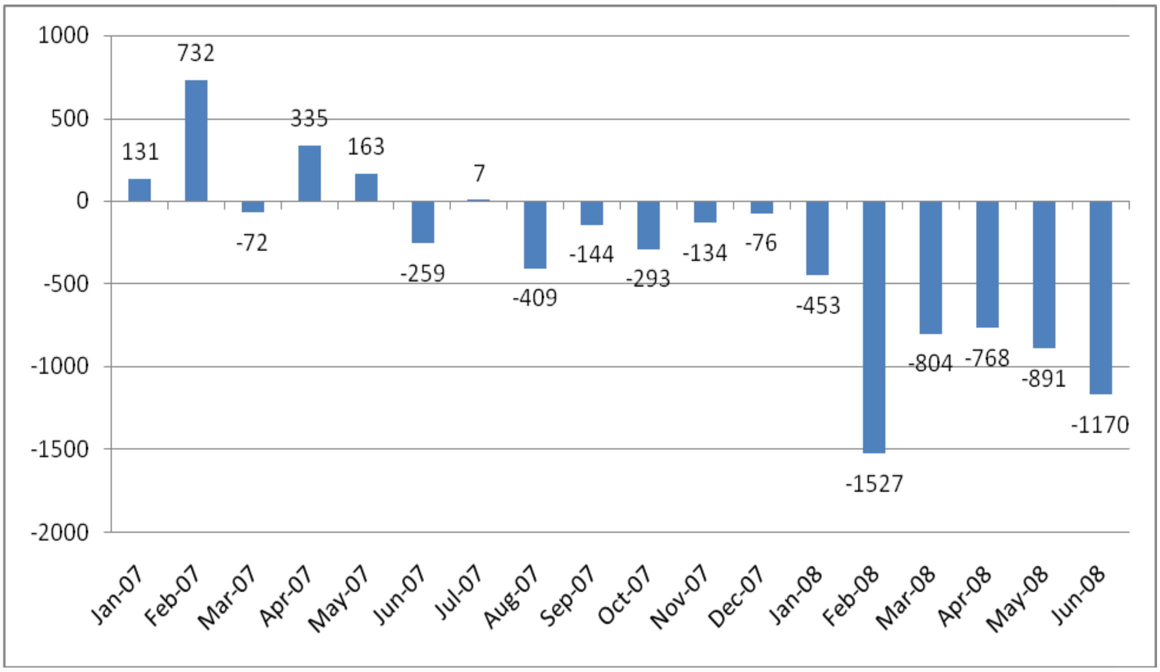


Source: Barclays Capital

For most of the first half of 2008, when oil prices began to rise sharply, OPEC resumed a passive role supplying the market upon demand at current international oil prices. It did not attempt to bring down prices by auctioning its spare capacity or offer discounts for refineries to lift its heavy sour crude. In a way, OPEC was comfortable with its position. A market in backwardation meant that there was no incentive for oil importers to accumulate inventories. At the same time, spot prices kept rising anyway as the market perceived low stocks as an indicator of low oil supplies and concerns about long term supplies intensified. Although there were clear signs of weakening demand, in such a market, excess supply does not appear as OPEC passively changes its output in line with oil demand.

The sharp rise in oil prices during the second half of 2008 created serious concerns about the potential impact of oil prices on OECD economies which were already showing signs of economic slowdown and potential financial problems. The data on US oil demand released by the EIA were pointing towards a sharp contraction. The year-on-year change in US oil demand turned negative in August 2007 and has remained negative since then (see figure 3). This, however, did not dent the rise in oil prices as oil traders continued to condition their decisions on the weak dollar.

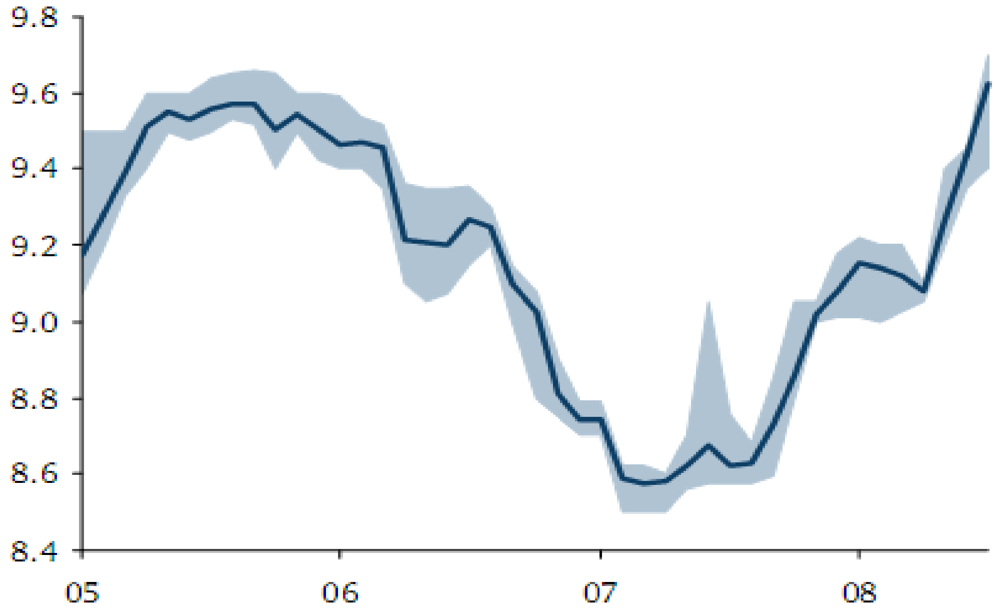
Figure 3: Year on Year Change in total US Oil Demand, Jan 2007-June 2008



Source: Energy Information Administration (EIA)

Amidst rapid rises and sharp volatility in oil prices and calls from oil importers to reduce oil prices, Saudi Arabia called for a meeting in Jeddah in June, 2008 and announced that it would increase its output by an additional 500,000 bpd outside OPEC quotas in an attempt to calm the oil market despite Saudi Arabia's insistence that the "market is well supplied". In fact, the upturn in Saudi output had already started towards the third quarter of 2007 and continued until August 2008 and saw Saudi Arabia's output increase by around 1 million bpd (see Figure 4). The decision to add 500,000 barrels per day could be considered as a change in supply-upon-demand behaviour towards a more active approach aimed at curbing the rise in oil price. Whether this 'additional output' was actually produced and taken by the market and whether it was responsible for the subsequent decline in oil prices is highly debatable. Oil prices reached their highest levels after the Jeddah meeting and there was not a rapid rise in inventories despite the slowdown in the growth of global oil demand. However, Saudi Arabia has been keen to take credit for the decline in oil prices with the Saudi Oil minister, Ali Naimi, claiming at September's OPEC meeting that the "market is fairly well balanced and we have worked very hard since June's meeting to bring prices to where they are now". The more plausible story is that once market sentiment turned negative, news about the extent of the decline in US demand intensified and maintained the negative sentiment, and more importantly, became the main public signal on which traders started to coordinate their decisions. In any case, this experiment to put a ceiling on oil prices was very short-lived and by September Saudi Arabia reverted to its old policy of supplying "whatever the customers want".

Figure 4: Estimates of Saudi Arabia Output (million bpd)



Source: Barclay's Capital

3. OPEC's dilemma

OPEC faces the risk that oil prices will undershoot as the market co-ordinates on public signals about the impact of the credit crunch and recession on global oil demand. It is important to stress that the extent of undershooting would be affected by the oil price term-structure. For instance, if concerns about long term supplies due to a slowdown in investment push up prices for future delivery, the market could reinforce contango with rapid accumulation of inventories. This could result in sharp falls in oil prices as accumulation of inventories signals abundance of supplies. On the other hand, concerns about long term demand can depress long term prices and this would reduce the incentive to accumulate inventories and may keep inventories at low levels.

Either way, OPEC faces a serious dilemma. There is no doubt that OPEC is under pressure to prevent a slide in oil prices, especially since many of its members have passed budgets at prices above $70 per barrel. In the meeting next Friday, OPEC plans to send a clear signal about its preferred range of prices and that the Organization is willing to defend the oil price by cutting supplies. Whether OPEC will succeed or not depends on whether the market thinks that OPEC possesses the discipline to implement these cuts. It also depends on the way the OPEC decision is presented to the market. Any disagreements between members about the price floor and who should bear the burden of the cut could dilute the signal.

If OPEC is able to anchor market expectations about its preferred price range, then OPEC can revert to its behaviour of supply upon demand at prices that OPEC is comfortable with. Given current market conditions, the risk is that OPEC may be forced to engage in excessive cuts over the next year or so for the market to take the Organization seriously about its $70 floor. For instance, the following suggestion from a market observer is quite revealing: “I suggest that with an oil price of $70 a barrel, members will push for a cut of at least 1 million bpd, anything less will be worthless in terms of the current crisis in the demand outlook”. The risk is that excessive cuts could eventually lead to sharp rises in oil prices and may worsen the global economic downturn depending on the size of the transfer and how it is being spent. These cuts can be self-defeating if they slow down the growth in global oil demand. High oil prices can also make monetary authorities in advanced economies reluctant to ease monetary stance and lower interest rates if they are worried about inflationary pressures originating from oil prices. Inability to offset recessionary pressures by monetary policy can increase the duration of the downturn. Moreover, OPEC leaders cannot politically afford to be seen to be contributing to the deepening of the world recession. In fact, calls have already been made for OPEC to refrain from such cuts. On 10th October 2008, the British Prime Minister Gordon Brown urged the leaders of OPEC “that they must not, as (some) of them are planning to do, cut oil production now so that the price will go up again. They must act in a statesmanlike way to help the rest of the world by making sure that we have a stable reduction in the oil price”.

Until the dust clears, an alternative plan for OPEC would be to do what it has done in the past year or so: to continue to supply the market upon demand at current international prices that is not to announce a quota cut. Some observers have argued that one of the lessons that OPEC may have to learn is that there is really no point in defending the oil price in the face of global recession and that in the long run, this strategy best serves the interests of its members if lower oil prices could help boost consumer confidence and speed economic recovery. However, reverting to this passive behaviour does pose a big risk for OPEC as it may send a signal to the market that OPEC approves and validates the fall in oil prices regardless of how fast and how low the oil price goes.

In practice, OPEC’s response to changes in oil prices is asymmetric. In a rising market, there is a bias towards adopting the more passive approach of supplying upon demand. On the other hand, in a declining market, there is a strong bias towards cutting supplies regardless of the context. This asymmetry in response implies that the perceived risks associated with a potential collapse in the oil price are too high for any of the members to be willing to bear and seem to outweigh the economic and political risks of adopting a more active strategy of cutting output.