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OPEC: Market is Over Supplied With Oil

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The 150th. (Extraordinary) Meeting of the OPEC Conference

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MARKET IS OVER SUPPLIED WITH OIL – GLOBAL DOWNTURN NOT CONNECTED TO HIGH OIL PRICE!

OPEC met today in an emergency session – branded the 150th. (Extraordinary) Meeting – and announced that production from its members would reduce by 1.5 million barrels per day with effect from 1st. November. This will be in addition to the cut announced last month at the 149th. Meeting of 520,000bpd. There were no real surprises as various ministers had quoted figures from 1 to 2mbpd and it was just a question of how far OPEC would go at this point. Was there a need for a meeting today? Probably not. The President and Secretary General of OPEC can announce such changes, having spoken to individual members but, without a meeting, the urgency and dramatisation of the situation would be lost and it is important from the OPEC perspective that its members' views are understood outside the OPEC environment.

As we approached the last meeting prices were hovering around the $100 level but yesterday were below $70. Last night Brent closed at $65.92pb and WTI at $67.84pb but this morning they fell to $60.98 and $62.65 respectively but then rose to $62.45 and $64.55 once the cut had been confirmed. The OPEC basket closed last night, down at just 60.27 from 60.82 on Wednesday. What was surprising was that even this morning prices continued to fall in anticipation of the news emphasising the seriousness of the situation. Perhaps fundamentals have returned?

This meeting was brief and most of the dialogue took place last night in private in a hotel. Today there was no open session and so no opportunity to ask Ministers directly what they were thinking although most had already willingly given their views on arrival in Vienna although the only joker was Ali Naimi the Saudi Arabian minister who just said "who said anything about a cut?" After the meeting, the statement given out advised that OPEC shared the concern of the international community over the financial turmoil and recognised that it was affecting the world economy and dampening the demand for energy, including oil. This was the cue to reiterate that the market was oversupplied with oil and point which OPEC has been making since earlier this year. It then moved on to state that falling oil prices would jeopardise existing and proposed oil projects which could lead to a medium term supply shortage but taking all in to account OPEC would continue to provide oil as required by consumers, in spite of the additional reduction in output of 1.5mbpd. This will supposedly reduce the production ceiling of the OPEC 11 from 28.808 to 27.508mbpd. Each OPEC member has been given a level by which to reduce and it will be interesting to see how they cope with it, against falling revenues.

The statement concluded that OPEC would continue "***maintaining crude oil prices at fair and equitable levels for the benefit of the world economy and the wellbeing of the market."*** **It also said that OPEC alone could not be held responsible for restoring prices to reasonable levels and called upon non-OPEC producers to fall in with the OPEC initiative. However, the real worry here is that OPEC and the consumers have a totally different view on what a reasonable price is with consumers hoping for less and OPEC for more!**

As we progressed in to the discussion session with the OPEC President HE Dr. Chakib Khelil, Minister of Energy & Mines of Algeria and Head of its Delegation, he was immediately asked what price OPEC sought and, as usual, with a smile he reminded us that price is always determined by the market but did not mention that OPEC acts and the market takes the initiative. In effect, OPEC manipulates the market just as it is now doing by cutting output.

The next question went further and asked if OPEC was concerned at taking such action when much of the world's economies were facing recession and this could make the slow down even worse. To this Dr. Khelil replied that when prices were high last year and even at $147 recently they did not have any effect on inflation or growth and he went on to say that this has nothing to do with the oil price but with the mismanagement of economies, the sub prime crisis and so OPEC, it seems, is dealing with the impact of the crisis on the oil sector. He also mentioned that inflation was going down and that oil had supported world economic growth.

Given the opportunity, I then made the point to OPEC that many manufacturing jobs had been lost in the US and Europe because of the high oil price. This has led to the migration of industry from West to East and I reinforced my view that the oil price had had a serious effect on western economies and that if the price went back up over the $100 level and the same consequences would be suffered and push them further back in to recession. I asked them to take note of this for the future. Dr. Khelil thanked me but did not agree with me! He went on to say that some members even increased oil production but it didn't have an effect in the price and that there was much speculation that drove the oil price up and he was right on this but OPEC did not increase last December when it had the chance to and by not doing so gave the opportunity to speculators to step in and push the price over the $100 level. OPEC was warned of this at the time.

Technically, OPEC did not have to take any specific action to drive the price up but circumstances were such that the price was did rise up and during this time OPEC members were the beneficiaries. For many years OPEC operated below the $30 level and now, having become used to such high earnings members are naturally aggrieved that such levels are no longer available to them and instead have the threat of even lower prices. There have to be two sides to every such market and here, for now, it would seem that the two – producers and consumers – are not in touch and this is evident from both sides.

The cut today of 1.5mbpd is a significant chunk off the OPEC total, around 5% with Saudi Arabia supposedly taking almost one third at 466,000bpd. Some Ministers, namely Iran, Venezuela and Libya would have preferred to have gone direct to 2mbpd. This would have been even more extreme and it could still happen. When questioned about policing the cuts, Dr. Khelil declared that each member of OPEC is affected by falling prices but he hesitated and then declared that they had no choice but to comply. With demand falling, many of them will be having some difficulty in selling their product anyway and so the threat of a cut back will probably take in to account cuts that are already taking place. The new output levels will be effective from 1st. November which is significant because at the last meeting he was uncertain as to when the cuts would take effect from.

In the run up to this meeting, consuming nations expressed their concern that OPEC would cut output to force the price back up, which is understandable and at a time when much of the world was facing recession. However, what irks OPEC is that many EU governments earn more from OPEC's oil than OPEC does and it does most certainly strain OPEC's culture to hear Gordon Brown the UK Prime Minister call OPEC's threat to reduce output as "absolutely scandalous". Mr. Brown has called upon fuel suppliers to pass on the decreases, and there is a difference between the crude price and the prices paid for Petrol and Diesel, yet with petrol at £1 per lire, the duty and tax element taken by the UK government amounts to a total of 65.24ppl – 65% while the refined oil element amounts to only 25% and OPEC would not have seen all of that either!

The statement and the hypocrisy of the situation astounds OPEC and the argument lacks credibility because, as the oil price falls, the share of governments that apply high taxation to petroleum products increases and if they are so concerned why don't they reduce the prices that their people pay? As a consequence, this situation certainly reinforces OPEC's view and understandably so, to balance the price more in their favour.

Looking back over recent months, as the overall situation developed, and since the OPEC meeting in April it was somewhat impressive that they managed to hold off from having another meeting until last month. They were unperturbed that price could rise close to $150 and with various forecasts claiming that the world would soon see $200 and that was only towards the end of June. Saudi Arabia stepped in and called the Jeddah meeting in June to reassert itself as the unofficial leader within OPEC and then offered to increase output, which it was scheduled to do anyway. Nevertheless the price peaked shortly afterwards and then began to fall leading up to the last meeting of OPEC in September. For OPEC, all it had to do was to stay calm and watch the market talk up the price.

At the 149th. Meeting last month, OPEC announced that the target or quota levels set as the output ceiling level for OPEC members should be adhered to although there was more subsequent conjecture that Saudi would not comply. Nevertheless a cut of 520,000 barrels per day as the world was struggling to cope with higher oil prices and facing the threat of recession was not particularly welcome. The demand profile was rapidly changing and at faster rate than many had recognised and oil prices continued to fall. The world had moved away from the conjecture only three months earlier of the imminent imposition of the $200 per barrel level, based on the premise that oil was close to running out, while now, just three months later it is the opposite and producers can not cut output back fast enough to keep up with falling demand.

Market conditions have changed so dramatically that it is too early to determine how far this will continue. We are still within the US hurricane season and with potential for seriously cold weather in the NE of the US and elsewhere in the world while geo-political incidents are never too far away. US demand stands at 20mbpd and it can not be alone in terms of cutting its own demand and so with perhaps 1.5mbpd taken out of the US requirement alone, there will have to be a reduction element for other parts of the world which is expected to have a total demand requirement of 87mbpd. The supply–demand ratio has been jeopardised and one can readily see OPEC's dilemma in terms of balancing its output with the world's demand.

Looking at the impact of higher oil prices it is worth remembering that four years ago the International Monetary Fund warned that $5 per barrel of oil for one year would affect world economic growth by 0.3% and at this point the figure of $30 was just a dream for OPEC. As oil prices have risen the, IMF has, it seems, distanced itself from this earlier statement and presumably because, as many perceived, the price of oil continued to rise almost unnoticed. However, on the way up, and before it hit the $100 level the statement was issued that the higher oil price had already wiped out the African debt relief. It is hard to accept that oil prices can rise from below $30 to close to $150 without any serious consequence to consuming nations. Against this, there has been some respite for those nations that purchase oil in non-dollar currencies such as the Euro and Sterling as the dollar has fallen against both but the impact of the increase has been significant.

OPEC has a difficult role to play and this is exacerbated by the differing views of its individual members. Cultural differences play a significant role as we have seen in statements made recently by Ministers. It would be useful if OPEC could set a price band at least as it used to do until early 2005. Then, at least, everyone would know the price range to aim for which is particularly important for budgetary purposes whether a consumer or producer. Some of the producers may be content in the $60 to $80 range while others need $90 to sustain their own budgetary objectives. The transformation of the market from the producers' perspective form below $30 to close on $150 with the belief that prices were sustainable at even higher levels must have created some severe adverse budget planning. Reality in the form of true fundamentals has returned and prices should be retained below the $100 level for the foreseeable future, but there are no guarantees as we have already learned.

OPEC is responsible for only 40% of world oil production but the observers, including Russia, that sit in on the meetings boost this number to around 60%. However, if OPEC cuts will non-OPEC producers increase to capture market share? Russia can join OPEC if it wants to but then will be subject to the same output rules as the others are supposed to be. It can exert pressure on OPEC although currently could not readily increase output without external support for International Oil Companies. OPEC may on have 40% but it is a co-ordinated body unlike the remaining 60% that is not. So, OPEC has a role to play and focus and blame will always be placed against it while praise and understanding may be short.

There has to be a fairer more equitable relationship between producers and customers. To be fair to OPEC, which does not regularly comment on or criticise consuming nations, it discreetly publishes a document "who gets what from oil" and this simply illustrates how the price of oil products to the end consumer is made up. OPEC actually has quite a deferential culture while encouraging comment on itself it will accept it good or bad but it is reluctant to openly comment on the views of others but if criticism continues to flow against OPEC this attitude will certainly change.

OPEC sees its role as the custodian of world oil supplies and in so doing should appreciate the impact that high oil prices have on world economies directly and indirectly. It maintains a policy of not discussing price but takes actions to manipulate the market and influence price. It needs to understand the ramifications of such actions. Yet, when analysing the cost of exploration and production consumers should recognise that OPEC's role is not entirely selfish and if greater return is achieved downstream one can not blame OPEC for exerting greater pressure upstream to achieve an equivalent return here as well.

I believe that OPEC is concerned that prices will fall further, in spite of these production cuts and this is probable but until there is some positive clarity over the global financial situation the position has to remain uncertain. For now I do not believe that prices will change significantly without some serious incident in the market. I know that OPEC will continue to monitor that market and as Dr. Khelil has said, a further meeting could be called if further action was required by OPEC to "stabilise" price further. The next meeting is scheduled to take place in December in Oran, Algeria, unless OPEC ministers do call for another meeting beforehand. Even if they do, the Oran Meeting could still happen to give Algeria, the presidency host nation, the chance to hold a meeting in its home country during its year of the presidency. Until then, we shall also follow the market closely.

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