

As oil prices plummet, OPEC meets to consider another production cut

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Representatives of the 12-member Organisation of Petroleum Exporting Countries (OPEC) are meeting tomorrow in Egypt to discuss a proposed cut in oil production aimed at halting the plummeting world price. The value of a barrel of crude oil fell below \$50 this month—just one-third of the record \$147 a barrel recorded in July—marking the sharpest price collapse since formal futures trading began in 1981.

The decline has been caused by the severe recessionary crisis wracking the world economy, with demand for energy sharply down.

Tomorrow's OPEC meeting is the third in as many months. None of the previous measures announced, including reduced oil production quotas, has had any impact on the falling price. The organisation—whose members are collectively responsible for 40 percent of world oil production—is expected to again downgrade its estimate for 2009 demand, after already doing so in each of its last three monthly reports. An element of panic is clearly evident among many OPEC members, whose domestic budgetary arrangements are being thrown into disarray by the lower value of their exports.

The meeting in Egypt was initially planned as an informal gathering of OPEC's Arab states, but was later expanded to include all members. Chakib Khelil, OPEC's president and Algeria's energy minister, has downplayed expectations of another oil production cut being announced. He insists that the meeting remains a consultative one, to assess the latest available data on world supply and demand for oil. The announcement of a production quota cut, he says, will only be made after an OPEC ministerial meeting to be held in Algeria next month.

But some members of the deeply divided cartel are pressing for immediate action. The Iranian and Venezuelan governments have publicly called for a 1 million barrel per day production cut.

In Iran, oil revenues reportedly account for 58 percent of

government spending. The 2008-2009 budget was based on an anticipated oil price of \$115 a barrel. According to an International Energy Agency (IEA) estimate, Iran needs an oil price of between \$86-\$95 a barrel to balance its budget. The country's foreign currency reserves are far lower than those of most of the Arab OPEC members, making it impossible to sustain large and prolonged budget deficits. President Mahmoud Ahmadinejad's government faces the prospect of slashing social spending and increasing taxes, measures that threaten to trigger social unrest and political instability. (See "Oil price drop undermines stability of Iranian regime")

The Venezuelan government of President Hugo Chavez faces similar pressures. With oil export revenues comprising nearly half of the government's budget, the previously high world price was a critical component of Chavez's nationalist project, the so-called Bolivarian Revolution. The IEA estimates that Venezuela needs an oil price as high as \$100 a barrel to balance the 2009 budget. According to the Caracas-based *El Universal* newspaper: "[D]omestic economic authorities have said that expenditures in 2009 would be governed by an austerity policy, as every dollar entering the country is [already] spent."

Russian President Dmitry Medvedev met with President Chavez in Venezuela on Wednesday. As well as signing new agreements for joint Russian-Venezuelan oil production and refining ventures in the country's oil rich Orinoco Belt, Medvedev expressed support for Chavez's demand for curtailed world oil production. Russia is the world's largest non-OPEC producer, supplying about 11 percent of the world's oil.

Russia's energy minister Sergei Shmatko said earlier that a price lower than \$95 a barrel could strain Russia's 2009 budget and put pressure on the rouble. He indicated that Russia might reduce its output in line with an OPEC decision to do so. But oil industry analysts expressed scepticism, noting that a lack of investment in the Russian sector has already led to declining production this year, creating pressure to maintain total export revenues by increasing output.

There is a general consensus in OPEC that a sub-\$50 a barrel price is too low. The *Financial Times* estimated that only Qatar, the United Arab Emirates, and Algeria could balance their 2009 external accounts at \$50. OPEC President Khelil said that member states had lost a total of \$700 billion in revenue in recent months due to lower prices and suggested that \$70-\$90 a barrel ought to be aimed for.

The Saudi Arabian government remains the most reluctant to cut production quotas. Saudi Arabia is the largest oil exporter in OPEC, accounting for nearly one-third of the organisation's total production. In previous periods, smaller member states have exceeded agreed quotas, leaving Saudi Arabia to sacrifice its production to prop up the world price. There are indications that the Saudi government is now less willing to let this happen.

"The Saudis have the longer-term view," Guy Caruso, a former US Energy Information Administration official, told the *New York Times*. "They don't want to be in the situation they were in the 1980s when almost all the burden fell on them to defend the price." Greg Priddy, an oil analyst with political consulting group Eurasia, added: "The Saudis will not allow themselves to be strong-armed. They want to see how everyone is complying [with existing quotas] before agreeing to another round of cuts."

Saudi Arabia also has an enormous sovereign wealth fund, leaving it better placed than other OPEC members to sustain budget and trade deficits.

The Saudi government left no-one in any doubt of its clout after an emergency OPEC meeting held in Austria last September. The meeting—convened as the oil price began to recede from its record high—was ostensibly aimed at preventing the price falling below \$100 a barrel. Member states issued a joint statement pledging to lower production and strictly adhere to set quotas. But just hours later, Saudi officials privately assured journalists and oil industry analysts that they would ignore the decision and continue to release as much oil onto the market as required.

These developments badly undermined OPEC's credibility. It remains to be seen whether the national rivalries of the different member states can be accommodated to reach an effective agreement on production quotas. But irrespective of the outcome of tomorrow's meeting in Egypt and next month's ministerial summit in Algeria, OPEC is incapable of addressing the root cause of the problem—the plunging world demand for oil.

The price of crude is one of the sharpest indicators of the worsening world recession.

Earlier this month, the US Energy Department estimated that national oil consumption for 2008 will fall 5.4 percent from last year, by a total of nearly one million barrels per day. This will be the lowest annual consumption of oil in the US since 1980. The oil price also reflects curtailed production and plant closures in many of the world's low-wage manufacturing centres, including China. On Wednesday the crude price jumped by 7 percent, nearly \$4 a barrel, after the Chinese central bank cut interest rates by more than one percent. *Wall Street Journal* commentator Keith Johnson noted: "As far as oil markets are concerned, there's still hope for the Chinese economy; America's been given up for dead."

There is enormous uncertainty about the likely average oil price over the next period. "At this point, all we can say with any degree of confidence is that crude oil will not trade below zero," industry analyst Stephen Schork declared last week. "Do not trust anyone in this market who tries to convince you that oil cannot go below \$40. The same way no one had a clue how high prices could go last July, there is no telling how low we can go now."

Deutsche Bank economists have predicted that a barrel of oil will reach \$30-\$35 a barrel by the end of next year, even if OPEC makes significant production cuts. They noted that even if quota cuts were agreed to, it may take six months or more before the change in supply registers on the market.

The falling oil price has led to concerns over the stability of long-term supplies. According to the IEA, a price of \$80 a barrel is required to make the necessary exploration and infrastructure investment economical. Earlier this month, IEA chief economist Fatih Birol reported: "We can see almost every day that projects are being cancelled due to the financial crisis."

Canadian-based energy investment firm Tristone Capital has estimated that global spending on oil projects will fall by 30 to 40 percent in 2009. Tristone also predicted that project cancellations and deferrals will result in insufficient supplies by 2011. The IEA's Fatih Birol warned that if world economic activity were to revive by 2011, the price of oil would likely exceed the peaks recorded earlier this year.



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