The latest production quota cut by the Organisation of Petroleum Exporting Countries has forced prices up, but will crude oil producers in Europe and elsewhere co-operate to help them stay up? *Eric Fishhaut* examines the situation

Opec keeps a tight grip

★ The 10-member Organisation of Petroleum Exporting Countries (Opec) announced production quota reductions at its last meeting on September 24. The cut – by 900,000 barrels – to the May 2003 level of 24.5 million barrels a day (b/d) took effect on November 1.

The market response to the cut has been an increase in the Opec basket price of nearly $5/bbl to just under $30, in only 13 trading days after the announcement (see figure 1). Such prices have not been seen since March and followed a drop of more than $3/bbl in the first three weeks of September.

Meanwhile, the Dated Brent assessment price published by Platts increased by over $6/bbl, from $26 to $32, (see figure 2) in the same time frame, and the West Texas Intermediate (WTI) crude price increased by nearly $5.50 to about the same level. In fact, the Brent price rose just above WTI, something that had not occurred since April 2002 (see figure 3).

The markets have peaked and settled back – with the Opec basket price retracing nearly $3/bbl, and Dated Brent dropping by more than $4/bbl – but they remain substantially higher since the Opec statement. Curiously, the Dubai crude assessment increased by only $3/bbl, or by about half that of the European crude price. But the European products market followed European crude, with unleaded gasoline prices rising well over $52 per tonne – or $6/bbl – in the three weeks since the Opec announcement (see figure 4).

In addition, the three oil grades that make up the Brent benchmark assessment are all scheduled for reduced production rates in November compared to October. A recent fire that claimed the lives of two men on the Brent Bravo platform continues to affect Brent production. As a result, the November output is the lowest-ever scheduled monthly production.

Meanwhile, Opec is eyeing further production cuts for December, and there is some speculation on increased demand for heating oil due to a cold winter.

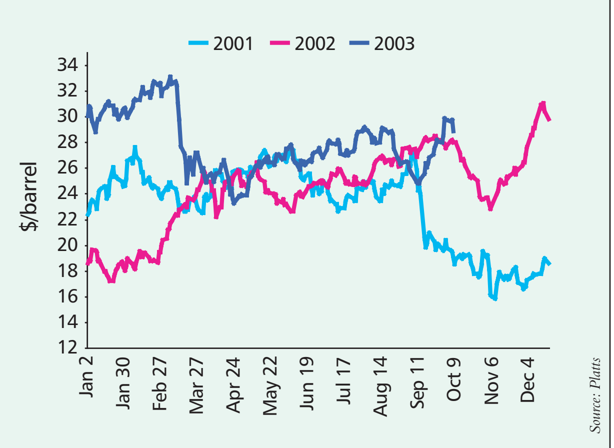
The current crude futures market is showing strong backwardation – that is, the price for nearby delivery is higher than for months further forward. Front-month futures contracts have been trading more than $2/bbl above the price of contracts for six months out.

Mixed results

The newly announced quota reduction is expected to have mixed results in the longer term, with some members cutting production, others resisting quotas and increasing production and others with internal problems that will force them to cut production.

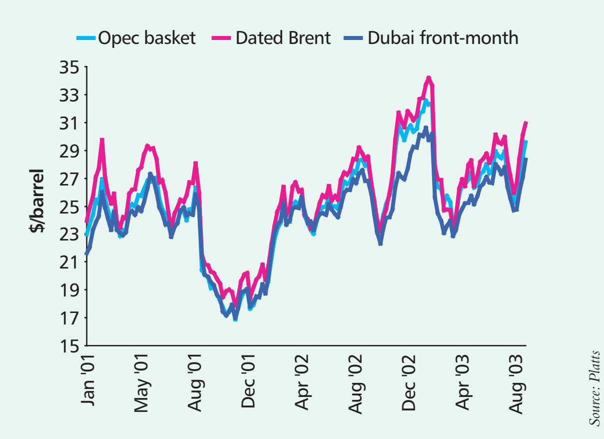
Algeria is well known for ignoring its quotas in order to gain

Fig 1. Year-on-year comparison, Opec basket price



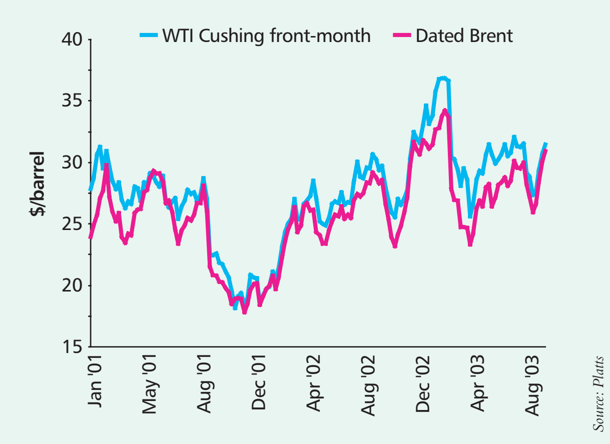
The Opec average basket price this year is consistently higher than in the previous two years and has fallen in the upper range of the target price of $22–28 a barrel or above.

Fig 2. Dubai crude v. Dated Brent crude v. Opec basket



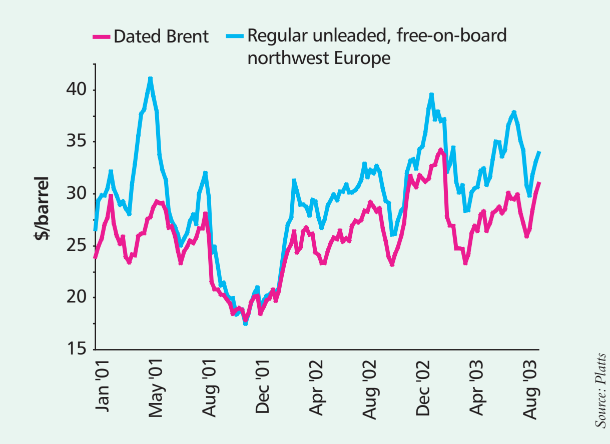
The price of Dated Brent, as assessed by Platts, is generally above that of the Dubai crude, as it is a sweeter and lighter grade, while the Opec basket price falls between the two.

Fig 3. **West Texas Intermediate crude v. Dated Brent crude**



The price of West Texas Intermediate (WTI) crude oil is usually higher than that of Brent, with exceptions only on a rare occasion The Brent price last exceeded the WTI price in April 2002.

Fig 4. **European unleaded gasoline v. Dated Brent crude**



The price of refined gasoline products will closely track the price of crude oil in the region, so price spikes in Dated Brent display immediate impact on the product market price.

greater quota share, while Libya and Nigeria are also seeking bigger portions. Production in Indonesia and Venezuela has been significantly below quota for technical reasons and is expected to suffer further declines in the upcoming months.

The EIA predicts that the Opec group's actual reduction because of the quotas will be between 500,000–600,000 b/d from their projected October level.

Longer term

Opec has said it will not cut its production any lower than 24 million bbls/day without additional cuts from non-Opec members such as Russia, Mexico and Norway. Historically, non-Opec members have not offered much support when oil prices have been near $30/bbl, as they are now. Only when prices have dropped to $15–20/bbl have such countries pledged supply cuts.

If predicted supply hikes from non-Opec countries and Iraq come to fruition next year, Opec will need to cut production further to maintain current price levels. In fact, if Iraqi oil production reaches pre-war capacity by April, as some analysts predict, an additional 1.3 million b/d above September 2003 levels will be available.

But these targets are conditional on improved security in Iraq, which does not appear easily attainable. Yet whatever happens, big price drops are unlikely, as Opec has successfully adjusted its production to keep the average monthly basket price within its target range for 42 of the past 47 months.

Opec is scheduled to meet next in December – no doubt it will have to make further adjustments. ER

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Opec price calculation and quota discipline

The Organisation of Petroleum Exporting Countries (Opec) calculates its average price based on a basket of seven crude oils, including those from Algeria, Indonesia, Nigeria, Saudi Arabia, United Arab Emirates (Dubai), Venezuela and Mexico (a non-Opec country). The Opec basket was introduced in January 1987 to monitor world oil market conditions.

The Brent crude price – the European benchmark – is generally higher than the Opec price, because it is a lighter, sweeter (low-sulphur content) oil. And the US benchmark – West Texas Intermediate (WTI) crude – carries an even higher premium, as it is yet lighter and sweeter (see figure 3).

Starting in March 2000, Opec set up a price band mechanism based on the Opec basket price, to respond to changes in world oil market conditions. Under the price band mechanism, production adjustments are made whenever Opec basket prices stay above $28/bbl for 20 consecutive trading days or below $22/bbl for 10 consecutive trading days. The adjustment was originally planned to be automatic, but the members were more comfortable with flexible production that can be fine-tuned.

Only once, on October 31, 2000, has Opec activated the mechanism – to increase the Opec production quota by 500,000 bbls/day. At least one Opec member, Venezuela, has expressed its desire to raise the price band to $25–32/bbl.

Opec began an experiment on June 1 seeking to bring production within its target quota by increasing the quota and asking for greater discipline by members. In fact, production did fall by more than 1 million barrels to an estimated 25.6 million bbls/day in September.