INSIGHTS

OPEC+ Keeps Production Rate Unchanged

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10 Mar 2022

I. WHAT HAPPENED?

On 02 Mar, the Organisation of Petrol Exporting Countries-Plus (OPEC-Plus) have agreed on their plans for minimal output rise of 400,000, in Apr 2022. In the statement after the meeting, the group has stated that the current fundamentals and the outlook for the future point “to a well-balanced market”. The move comes to the dismay of analysts and oil-importing countries, who have been calling for the group to increase the production of oil to offset the record-high prices for crude oil.

II. BACKGROUND

On 02 Mar, the Brent crude oil index price touched USD 113.94 per barrel for the first time since 2014. The price of the crude oil has been constantly on the rise as many countries have not been able to meet their production obligations of 400,000 bpd. The prices then started to increase further since 22 Feb when Russia announced the recognition of the independence of the breakaway regions of Donetsk and Luhansk and the announcement of sending peacekeeping forces into the regions. On 25 Feb, Russian President Vladimir Putin announced that Russia will conduct a “special military operation” in Ukraine to “demilitarise” and “de-nazify” the country. This shocking development has sent the price of crude oil at record levels since 2014.

III. WHY IS THE GROUP NOT INCREASING THE PRODUCTION OF CRUDE OIL?

The analysts have criticized the group’s decision to not increase the production of crude oil to stabilise the supply-side increase in prices. The analysts have been critical of the group’s reasoning for the volatility in prices on “geopolitical developments”.

One of the reasons for the group not increasing the production may be that Russia’s Deputy Prime Minister Alexander Novak is a co-chair of OPEC-Plus. Russia produces 10 million BPD per day, making it the second-biggest producer of crude oil, it also is one of the largest exporters of crude oil, with 5 million BPD. The sheer production capabilities of Russia put it in a formidable position in the group along with Saudi Arabia, both countries have a fair understanding of not flooding the market with excess supply.

The second reason is associated with Russia, as the invasion of Ukraine has drawn stringent sanctions from the Western allies, including removing the biggest Russian banks from the Society of Wireless Internet Financial Transactions (SWIFT) system and imposing sanctions on the Russian Central Bank. This has led to the sudden decline in the demand for Russian crude oil, as investors are looking towards alternatives. About 70% of Russian crude oil is being affected, and the demand is decreasing even though the prices have reduced by 20%. Due to major shipping companies suspending operations in Russia and Belarus, freight rates and insurance premiums for dealing with Russian crude oil have also increased.

IV. HOW ARE EXPORTING COUNTRIES MANAGING THE PRICE VOLATILITY OF CRUDE OIL?

The uncertainty around the aftermath of the Russian invasion of Ukraine, the investors are worried about the possible response of the group in the future to stabilise the prices which may affect the global economic recovery, post-COVID-19. Although, some countries part of OPEC have shown interest to unilaterally increase their production to ease the volatility of crude oil.

Iran

- Iran has the fourth largest oil reserves, but crude outputs have drastically dropped since 2018, after USA imposed sanctions.
- Iran has been vocal about increasing its oil production once USA lifts sanctions once the nuclear deal is reached.
- The Iranian Oil Minister Javad Owji has claimed that Iranian oil production capability will reach its maximum level in less than two months.
- Iran produced 2.4 million BPD in 2021 and plans on increasing output to 3.8 million BPD if the sanctions are lifted.

Saudi Arabia

- Saudi Arabia and its allies including United Arab Emirates may unilaterally increase the production of oil or release oil from its Strategic Petroleum Reserve.
- There have been instances where the de-facto leader of OPEC has done that, the recent instance being in the month Dec 2021, when Saudi Arabia met its quota of increasing its production by 400,000 BPD and released more crude from its SPR.

Venezuela

- Venezuela in Dec 2021 had boosted its oil production to 1 million BPD, almost double since the US sanctions were imposed on the Latin American country.
- The oil and gas industry which is completely state-owned recently modernised with the help of China, therefore increasing its production capacity.
- On 01 Mar, the Venezuelan President in a press interview has stated that his country is ready to boost the production from 1 million BPD to 3 million BPD, “in a short time”. He has invited US, European, South American, and Asian investors to invest in Venezuelan oil.

V. WHAT NON-OPEC MEMBERS ARE DOING TO MITIGATE VOLATILITY?

USA

- The US Secretary of Energy had released a statement that following a meeting with International Energy Agency (IEA), USA has committed to release 30 million barrels of crude oil from its Strategic Petroleum Reserve.
- The statement has hinted towards USA is willing to release more crude oil into the market in order to mitigate the price volatility of crude oil following Russia's invasion of Ukraine.

International Energy Agency (IEA)

- The emergency meeting of all the 30 members of the IEA, led to an agreement of the member countries to release a total of 60 million barrels of crude oil into the market.
- The 60 million barrels of crude oil is 4% of the emergency stockpile of 1.5 billion barrels of crude oil held by IEA.
- The agreement includes member countries from the European Commission, Japan, Australia, and South Korea.

Germany

- Germany as part of its commitment to stabilise crude oil prices has released 434,000 tonnes of crude oil, which equals to approximately 10 million barrels.
- The amount released is 3% of Germany's oil reserves.

China

- In an act of defiance, China has continued to boost its crude oil purchases to increase its oil reserves.
- USA had requested China to release crude oil into the international market to stabilise the prices.
- China's state-owned oil company Sinopec has increased its crude oil inventories by 30 million barrels since Nov 2021, with 10 million in refineries and 20 million in terminals.
- China has bolstered its total crude oil supplies to 950 million barrels as of Feb 2022.

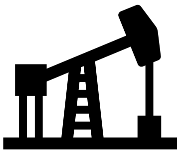
India

- As of 26 Feb, India had released 3.5 million barrels of crude from its reserves, which was part of its 5 million barrels agreed in Nov 2021.
- India has publicly stated that it will commit to releasing more into the international oil market if all the oil-importing countries feel the need to do so.
- India is seeking extra crude oil from Middle Eastern producers for Apr 2022, fearing western sanctions may hit Russian Urals crude oil. The possibility of the request being accepted is high, as in the past during the Iraqi invasion of Kuwait, India managed to increase crude oil supply from Saudi Arabia and Iran.

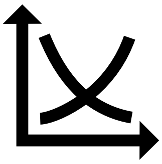
VI. ASSESSMENT

The problem of supply-side inflation of crude oil

The major problem with the supply-side inflation on crude oil is that in the long run, it may lead to stagflation. Asian economies rely heavily on imports for meeting their crude oil demand. This will slow down the manufacturing sectors of economies like China and India, as the costs of operations will increase, hence slowing down the growth of the jobs market. This is a situation where stagflation takes into effect, a prolonged state of stagflation will lead to the contraction of Gross Domestic Product of the world, and when this continues for consecutive quarters, it will lead to recession



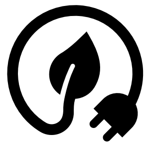
This exact turn of events was seen in 1970s when the demand of crude oil was high, but the supply did not meet the demand, leading to the prices in the US reach USD 110 per barrel (adjusted to inflation). The importing countries such as USA, Japan, and Europe faced recession from 1973 to 1979, and due to this, the demand for crude oil plummeted.



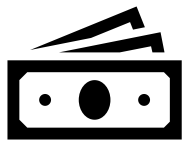
The situation will not take a lot of time to turn from bad to worse, due to the global interconnectedness of all the economies, and the high costs of isolating Russia in a global economy that relies heavily on the oil production capabilities of the country.

How will the increasing crude prices affect energy transition?

During the joint statement after the IEA emergency meeting, the US Secretary of Energy Jennifer M. Granholm stated that the US believes that investing in clean energy is the best way to reduce domestic and international dependence on Russian oil and gas. However, it is to be noted that the IEA was formed after all net importing countries felt the wrath of prolonged growth contraction.



Today, as the US and its allies try to alienate Russia for its war on Ukraine, the IEA will have to pressurise other oil-exporting countries to boost oil production to offset the lack of Ural crude oil in the international oil market. Countries such as Saudi Arabia and even USA, who have pledged to invest in alternative sources of energy will require to redirect the resources to boost their oil production to stop the repeat of the situation the net importing countries faced in the 1970s.



FUTURE OF RUSSIAN OIL AND GAS INDUSTRY

The Russian oil and gas industry will face the increasingly difficult task of continuing to grow as Western allies will seek alternatives to reduce dependence on Russian hydrocarbons and natural gas. The most likely outcome will be replacing the Western consumers with China, which has been the case since 2008.

Gas sector

Russia has a direct replacement to the now-suspended Nord Stream 2 gas pipeline, in the form of the Soyuz Vostok gas pipeline which will go through Mongolia into China. On 26 Feb, Gazprom signed a contract for the design and survey work as part of the pipeline, which will deliver up to 50 billion cubic metres of natural gas every year. The Nord Stream 2 in comparison would have the maximum capacity to deliver 55 billion cubic meters every year to Europe.

Europe cannot completely offset Russian natural gas, as the Nord Stream 1 will continue to send gas to the gas terminals of Europe in the longer run. Currently, Russia sends up to 50 billion cubic meters of natural gas through Nord Stream 1. As of 03 Mar, the value of Europe imports of Russian gas steadily increased since 01 Jan 2022.

OIL SECTOR

The Russian crude mix of Urals crude is being snubbed by the international markets as they fear the Russian oil and gas companies may face direct sanctions if the war in Ukraine continues. The Canadian government has banned the Urals crude imports, which was 7% of Canadian oil imports; the USA is considering an import ban of Urals crude, and according to the S&P Global, US imports of Russian oil fell to zero, since 25 Feb. India's state-owned Indian Oil Corporation has stopped the import of Russian crude on a free-on-board (FOB), due to high insurance premium and freight charges. However, these changes are temporary for the Russian crude demand for the following reasons

VII. CONCLUSION

Canada will stop the public funding for the expansion of the Trans Mountain Oil Pipeline, which delivers approximately 300,000 barrels every day through the 1,150 km of pipeline in Alberta and British Columbia. This expansion was key to meeting the long-term demand of the Canadian economy. Canada will have to reassess its interests and take Russian crude oil to fulfill a small portion of the supply deficit the suspension of the Trans Mountain Oil Pipeline expansion project will lead to by the end of 2022.

Companies like Shell have decided to take advantage of the falling demand of Urals crude and went on to buy from the Swiss trader Trafigura at a record low price of up to 30% discount of the current market price. Similarly, USA and Japan will look to replenish their Strategic Petroleum Reserves by buying Russian crude at lower prices than Brent and West Texas crude. The reason is, boosting production takes several months and currently, demand is outpacing supply for Brent and West Texas crude.

Net importing countries like China and India have had close economic ties with Russia, both countries may take the opportunity and place delivered basis contracts for Russian crude. The delivered basis contracts mean that Russia and Russian-based oil companies have to take full responsibility for delivering the crude oil through the sea to the place of delivery. Indian company Bharat Petroleum has an arrangement where it imports a blend of the Russian Urals and the Kazakh CPC for its refineries on a delivered basis. Plus, India looking to cut the operation costs of Bharat Petroleum, to make it attractive before it's Initial Public Offering (IPO), it will not be a surprising step for Bharat Petroleum to increase its dependence on Urals crude.

The Russian energy shock will continue to support high prices if Russian oil exports decline by two million barrels per day or more. OPEC+, of which Russia is a member, has been extremely conservative in increasing production despite calls from Western countries to boost production. With oil and gas production in the United States shale patch unable to surge quickly, oil-producing countries like Saudi Arabia can take advantage of the shortage with few consequences and continue to reap the benefits of higher prices, which are crucial to funding state-led economic diversification platforms. Saudi Arabia's poor relationship with US President Biden only makes Riyadh less willing to boost production.

ABOUT THE AUTHOR

Sooraj Kashyap is a Risk Analyst responsible for the regions of North and Latin America focusing on risk and threat assessments. He looks into Regional and Geopolitical analysis. He holds a Masters' degree in International Studies from Symbiosis International University, Pune, and a degree in Political Science from the University of Calcutta.