OPEC's production forecast causes sharp drop in oil price

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It's turmoil in the energy markets and in the oil industry more specifically, after OPEC – the economic cartel of some of the world's largest oil producers – decided in November not to cut production in the wake of a recent slide in prices.

Global demand for oil has gradually slowed down, with a reduced growth in China's economy as well as a stagnant Eurozone. In terms of supply, the increase in US shale production in recent years meant that North America is not importing as much oil as before, with a projected shale provision increase set to make the United States the world's biggest oil producer in the next few years. The net effect is that oil reserves are growing while prices are plummeting.

In their 166th Conference on the 27th November OPEC members reviewed the oil market outlook, taking into account the above factors and concluded that they would keep the rate of oil production unchanged, in an effort to balance economic growth and acceptable returns.

A number of OPEC member countries are significantly dependent on oil price to balance their budgets and narrow their government deficit. Such members would likely have favoured a production cut in oil to reduce supply in an attempt to maintain prices at a suitable level. Other producers – chiefly Saudi Arabia, the biggest oil producer within OPEC – are capable of producing oil at a much lower cost. For such countries a market with lower oil prices can be seen as a necessary trade-off in order to retain market share.

Some market analysts see ulterior motives behind OPEC's decision – namely a de facto "price war" towards countries such as the US, by endeavouring to render shale gas production unprofitable and shake the weakest competitors out of the market. Such a scenario is not so remote; with some US producers having already downsized the amount of oil rigs they operate and others forecasting production and budget cuts for next year, the US shale industry is seen as undergoing an endurance test, increasing pressure on cutting costs and improving operational efficiencies.

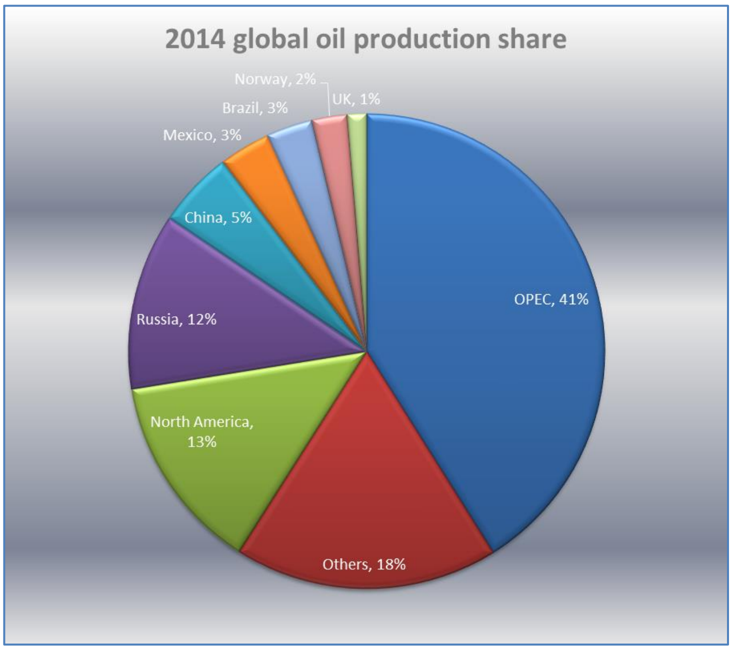

Figure 1 - OPEC's influence is still apparent

There are potential pros and cons deriving from lower oil prices. Benefits mainly point to global economic stimulus derived from access to cheaper energy; there are also potential geopolitical advantages: Russia, a major oil producer, is suffering from weak growth and could be forced to review its stance on Ukraine to avoid cutting back on budget spending, in a bid to have Western sanctions lifted.

In terms of threats, an extreme reduction in oil prices is seen by some analysts as a potential catalyst for systemic risk. OPEC members are not immune to risks either, as a number of them are largely dependent on oil production and undesirably low prices may trigger internal rifts between different members, with potential further destabilisation of the market as a whole.

Outlook

It is unlikely that we will see a market correction in the near future. The target price for Crude Oil for year end is in the region of 55-60 dollars per barrel, unless further developments prompt OPEC members to respond earlier than anticipated.

Figure 2 - Crude Oil price forecast, end of 2014.