TD Economics

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OPEC agrees to cut production to 32.5 million barrels per day

- The much anticipated OPEC meeting ended with a deal to cut production to 32.5 million barrels per day (a cut of roughly 1.2 million barrels per day according to OPEC), beginning on January 1st, 2017. The agreement is for six months, and extendable for another six months depending on market conditions.

- Under the agreement, Saudi Arabia will bear the brunt of the cut in absolute terms, with a reduction of 486k barrels per day. Still, this leaves output from the cartel's largest producer close to the elevated levels seen earlier this year. Iraq will cut by 200k barrels per day, which will leave the member country also producing at historically high levels. Iran's output will be capped at just under 3.8 million barrels per day.

- Nigeria and Libya are exempt from production cuts given that output in these countries has been hampered by unrest and sanctions. However, both countries have a lot of room to ramp up output should conditions become favourable.

- A monitoring committee will be established to monitor the implementation and compliance of the agreement.

- The deal was reached following an understanding that key non-OPEC countries would reduce production by 600k barrels per day. Details on where these cuts would come from were not provided, although the Russian Federation was mentioned.

Key Implications

- The fact that OPEC member countries have signaled their intent to help bring the market into balance is a positive for oil markets. Initial market reaction was indeed positive, with the WTI benchmark jumping by over 8% to US$49 per barrel. However, once markets have time to digest the news, there could be some give back.

- The deal is for 6 months, or possibly a year, suggesting that after that timeframe, production could shoot back up as OPEC producers resume their fight for market share. What's more, OPEC members are notorious for producing above target levels, which would prolong the rebalancing process. And, the exemption of Libya and Nigeria presents some upside to OPEC's total production. Until markets see an actual cut in production, prices will be hard-pressed to gain much further ground on a sustained basis.

- Russia's supposed agreement is also a positive for markets, but it is important to note that the country is producing at record levels. A cut of 500k barrels per day – which is a generous assumption for illustration purposes – would bring it back to the then-record output levels seen a year ago.

- The U.S. is not part of this deal, and if prices rise to above US$50 per barrel, hedging activity is likely to pick up, helping to prop up production there. Moreover, if prices were to hit the mid-to-high US$50 per barrel range, that would likely be enough to trigger investment in the shale sector, also leading to higher production levels, and limiting any price increases.

- All told, if OPEC is able to adhere to these quotas, it would help to reduce the glut that has plagued the market over the last two years. We suspect that some production will be scaled back, but perhaps not the full amount. As such, we expect prices to trade in the US$45-55 per barrel range over the next year, reaching the higher end of that range by mid-2017 as the market shows some signs of rebalancing.

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