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U.S. Overreaction to OPEC+ Production Cut

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OPEC and its partners such as Russia, known as OPEC+, announced on October 5 that it will cut its total oil production quota by two million barrels per day. This decision, its impetus, and implications have been badly misunderstood in Washington. Rather than a drastic politically-motivated production cut that will send oil prices skyrocketing in order to aid Russia and spite the United States, the move will result in a modest actual production cut, based on economic considerations driven by OPEC+'s forecast of dwindling global oil demand. The United States should avoid overreacting to the OPEC+ decision and should reengage in discussions with Saudi officials on how to rebuild a more constructive partnership between Washington and Riyadh.

What Happened?

- In a decision spearheaded by Saudi Arabia and Russia, the Organization of the Petroleum Exporting Countries and its partners (OPEC+) agreed on October 5 to reduce "required production levels" by 2 million barrels per day (mmb/d).

- In response, President Biden on October 11 condemned the move, promised "consequences" for what Saudi Arabia did "with Russia," and warned the United States must rethink its relationship with Saudi Arabia. The administration also reportedly cancelled a key meeting with Saudi Arabia and other Gulf states on regional integrated air and missile defenses.

  » On October 12, the Saudi Ministry of Foreign Affairs released a statement emphasizing the "purely economic context" of the OPEC+ decision and claiming that they consulted closely with the Biden administration, which had asked them to hold off announcing the decision for a month to avoid impacting midterm elections in the United States.

Why Is It Important?

- Contrary to its portrayal in Washington as a massive production cut that will send oil prices skyrocketing, made in order to aid Russia and spite the United States, the OPEC+ decision is a voluntary production quota cut that will have a much more modest impact and was made for primarily economic reasons – bringing supply in line with declining global demand.

- By misunderstanding the nature and intent of the OPEC+ decision, the Biden administration's response threatens to achieve precisely what it is trying to avoid: pushing Saudi Arabia further from the United States and closer to Russia and China.

- Though commonly described as a "production cut," the OPEC+ decision is actually a reduction in the *maximum production quotas* for each of 20 countries party to the agreement.

  - According to its own statement, what OPEC+ decided to do was "adjust downward the overall production by 2 mmb/d [million barrels per day] from the August 2022 *required production levels*."

  - "Required production levels" refers to OPEC cap on maximum oil production by its member states.

  - Many countries already fall short of both the existing August 2022 production quotas and the new, reduced quotas that will now go into effect in November 2022.

  - Moreover, the downward adjustment to production quotas is, per OPEC, voluntary.

- As explained in a JINSA webinar on October 7 and an op-ed by Michael Makovsky and Blaise Misztal on October 19, the 2 mmb/d reduction in OPEC+ quotas will result in an actual cut between 0.5 and 1.2mmb/d, since many of the OPEC+ countries will not actually have to cut production in order to meet the new, lower quotas.

  - For example, Russia's August 2022 quota was just over 11 mmb/d, and its new, reduced production quota is roughly 10.5 mmb/d. However, it is only producing 9.8 mmb/d and is set to keep producing at that level, putting it below the new quota without having to make any reductions to production.

  - Of the 20 relevant OPEC+ countries, 13 were already producing at or below the new quotas in September. Iran, Venezuela, and Libya are exempt from cuts.

- This voluntary quota cut is primarily a reaction to fundamental economic indicators, an attempt to bring supply in line with demand that has flagged far below expectations.

  - Heading into 2022, OPEC expected global oil demand to grow by 3 mmb/d, but by October 2022 it has become clear that demand is at least 1 mmb/d short of that target. That same month, OPEC cut its demand growth view for 2022 by 460,000 b/d to 2.64 mmb/d and for 2023 by 360,000 b/d to 2.34 mmb/d.

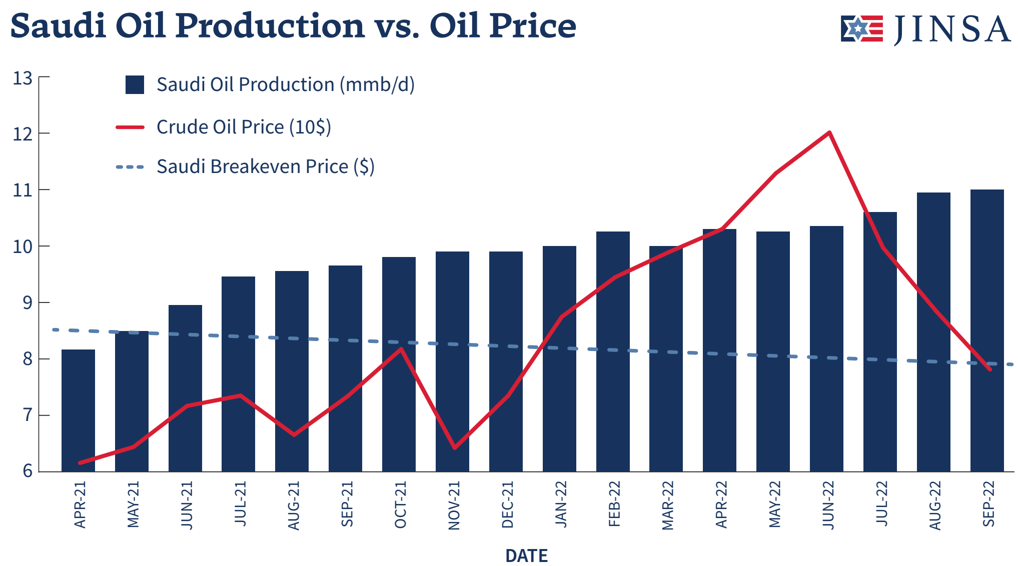
  - As a result, production—which could not keep up with demand for most of 2021—has outpaced demand throughout 2022, to the extent that the August 2022 production quotas would have created a global supply surplus of 1.0-1.5 mmb/d.

  - In this context, from the time of Russia's invasion of Ukraine in February 2022 through August 2022, Saudi Arabia gradually increased production by about 700,000 b/d, contributing in part to a nearly 50 percent decline in oil prices over the summer.

  - As surplus stocks built up, that discrepancy between supply and demand would have driven the oil price below the breakeven point for OPEC producers.

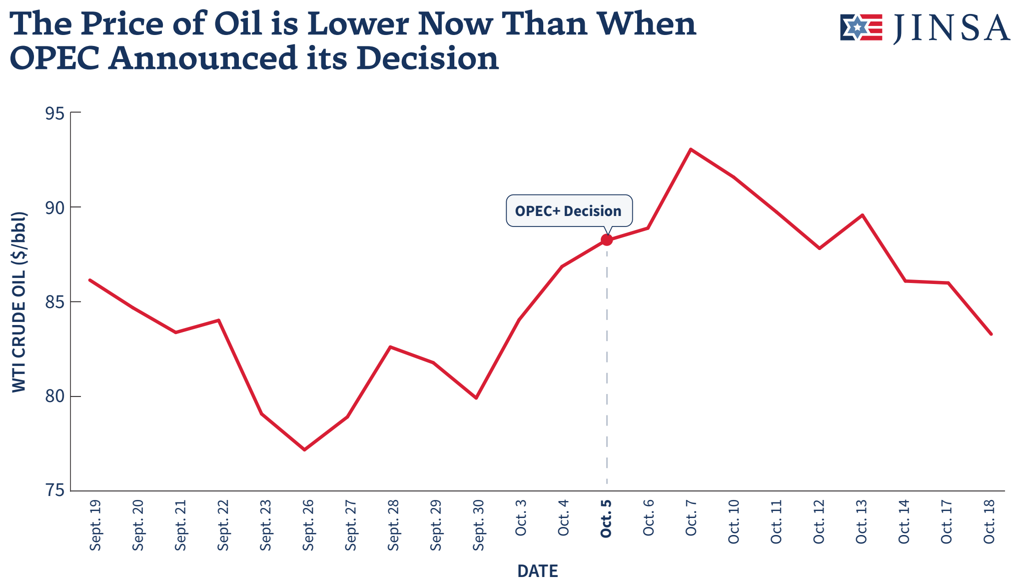
- The price of crude oil dropped to a low of $76 per barrel in September, after hitting highs above $120 earlier this year.

- Saudi Arabia's breakeven price is considered to be in the high $70s.



» The Saudis and OPEC+ countries had been discussing a production cut for months "to correct a recent oil price decline driven by poor futures market liquidity and macro-economic fears."

» Given all these factors, the expected OPEC+ production cut is a sensible response to the alternative of a global supply surplus of 1.0-1.5 mmb/d based on the previous quotas.

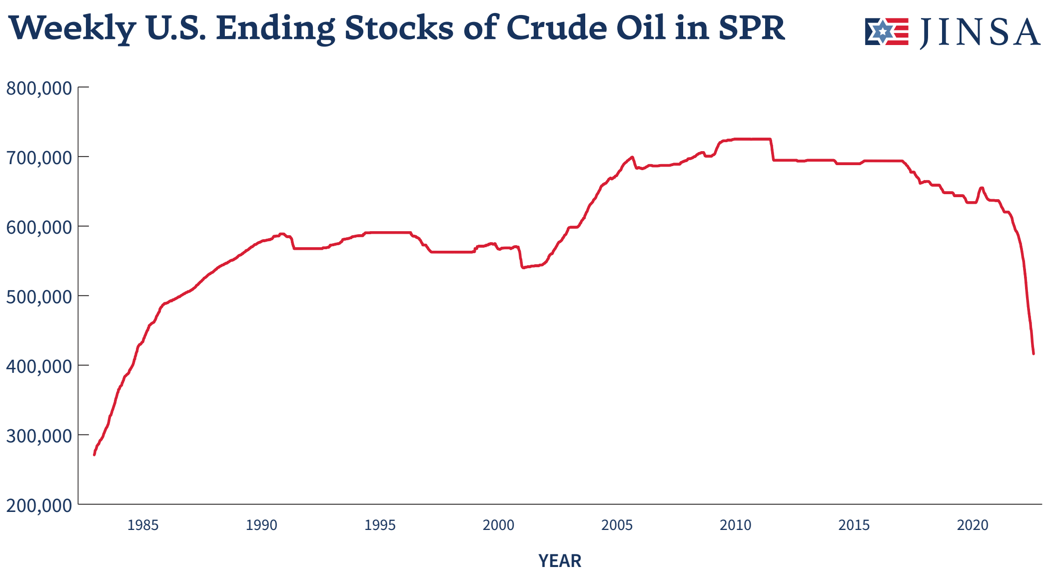


- An additional factor in the OPEC+ decision was the attempt by the United States to lower rising oil prices by releasing strategic reserves.

» President Biden began releasing large quantities of oil (50 million barrels) from the U.S. Strategic Petroleum Reserves (SPR) in November 2021, months before the Ukraine crisis, in a bid to lower skyrocketing gasoline prices that resulted from post-COVID demand for oil outstripping supply.

» After Russia's invasion of Ukraine in February 2022, efforts to curb Russian oil exports and revenues exacerbated spiking gasoline prices, leading Biden in March 2022 to announce the release of 1 mmb/d from the SPR for up to 180 days, the largest such release in history.

- Consequently the SPR is now at its lowest level in nearly 40 years, creating a strategic risk for the United States in the event of a real supply disruption.



» Moreover, in a further bid to bring down energy prices, in October the U.S. Treasury proposed a price cap on Russian oil.

- If successful, such a cap would effectively create a buyer's cartel capable of dictating to producers what price they must accept for their oil.
- As viewed from Saudi Arabia, the same strategy could in theory be used in the future to target the Kingdom, which would pose an unacceptable threat to the foundation of the Saudi economy and Saudi geopolitical influence.
- This push for a price cap expedited the OPEC+ production cut. Early this month, the Saudi energy minister reportedly told OPEC+ delegates that the U.S.-led price cap on Russia was a direct attack on producers and "it's us against them."

U.S.-Saudi Relationship Moving Forward

- The Saudi-led OPEC+ decision was made in a context of strained bilateral relations with the United States.

- Despite President Biden's July visit to the Kingdom in an effort to repair relations, tensions remain high due to his continued public criticism of Saudi Crown Prince Mohammed bin Salman (MBS) over the 2018 Khashoggi murder and the administration's relentless efforts to revive an Iran nuclear deal that would deliver tens of billions of dollars in sanctions relief – and pave a path to nuclear weapons – for Saudi Arabia's most dangerous enemy.

- In discussions prior to the OPEC+ decision, U.S. officials explicitly warned the Saudis that a significant production cut would be viewed by many in Washington as a hostile act designed to help Russia and harm the United States – especially President Biden and the Democratic Party – by increasing gasoline prices just before the U.S. midterm elections.

- The Saudis disregarded these warnings and proceeded with the cut almost entirely on the basis of protecting and advancing the Kingdom's own economic interests.

- Saudi Arabia's economy is forecast to grow by more than 8 percent this year, one of the highest in the world—at least theoretically providing the Saudis with enough of an economic cushion to go along with the Biden administration's request for a one-month postponement of the OPEC+ decision, if they had been so inclined.

- The U.S. overreaction to the OPEC+ decision, which has thus far included promising serious consequences for Saudi Arabia, rethinking the relationship with the Kingdom, and cancelling important upcoming security meetings, will only accelerate the erosion of relations to the detriment of regional deterrence against Iran, and to the benefit of great power rivals Russia and China.

  - The decision to cancel the upcoming meeting on integrated air and missile defense with Saudi officials is especially disappointing, given that progress on this issue would benefit U.S. interests in the Middle East, and because it contrasts starkly with the Biden administration's refusal to end nuclear negotiations with Iran at a time when the regime is brutally oppressing Iranian protesters and targeting American citizens for assassination and kidnapping.

- President Biden's response to the OPEC+ move suggests a lack of appreciation for how Riyadh is acting in its self-interest rather than aiding Russia or hurting the United States.

  - The United States has many partners with whom it does not see eye-to-eye on key issues. India, for example, has ignored Washington's pleas to curb purchases of Russian oil while Turkey, a NATO ally, has refused to join Western sanctions against Russia.

- In light of the continued mutual benefits of a strong bilateral partnership, both the Biden administration and Saudi Arabia would be well advised to look for ways to de-escalate current tensions and rebuild ties.

- For its part, the United States should use the international uproar over the Iranian regime's brutal oppression of anti-regime protesters and its entry into the Ukraine war on Russia's side as an opportunity to rethink its failed Iran policy by siding with its traditional partners, especially Saudi Arabia, in a U.S.-led effort focused on diplomatically, economically, and militarily constraining and defeating Iranian aggression.

- Such a strategy would include ending stalemated talks over Iran's nuclear program, fully enforcing existing U.S. sanctions and adding new sanctions, coordinating with allies to increase international support to the Iranian people and the diplomatic isolation of the Iranian regime, and making clear that the United States is prepared to use force in defense of Saudi Arabia should Iran attempt to distract attention from its internal problems by lashing out against the Kingdom.

- Moves by Riyadh to underscore its opposition to Russia's aggression should be welcomed, and more encouraged.
    - On October 12th the Kingdom voted with the United States in support of a UN resolution condemning Russia's illegal annexation of parts of Ukraine.
    - On October 14, MBS called Ukrainian President Zelensky. Zelensky thanked the crown prince for Saudi Arabia's UN vote in support of Ukraine, as well as for a new $400 million Saudi humanitarian aid package, which Zelensky reportedly said the Ukrainian people would never forget and which proves the Kingdom's friendship to Ukraine.
    - In mid-September, Saudi Arabia helped broker the largest prisoner swap between Russia and Ukraine since Russia's invasion. White House National Security Advisor Jake Sullivan tweeted, "We thank the Crown Prince and Government of Saudi Arabia for facilitating."

- Both Washington and Riyadh should make it an urgent priority at the highest levels to do a much better job of coordinating their positions and messaging in advance of the next OPEC+ meeting in early December, to ensure that the results contribute to stabilizing their strategic relationship.