Shale Holds Cards in OPEC's Houston Gambit
Backroom boys have no common interest in cuts.

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Data Sources for This Publication
U.S. Energy Information Administration

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Cartel Plays Second Fiddle

The OPEC/NOPEC agreement to curb oil production, which commenced in January 2017, has arguably served its purpose by reviving oil prices from their 2015 slump to over $60/barrel this year. The cuts have trimmed excess inventories and encouraged higher prices in a tighter market. The biggest challenge going forward to OPEC/NOPEC efforts to balance supply and demand is surging U.S. shale production. With shale up over 1 million barrels/day in 2017 and expected to increase by another 1 mmb/d in 2018, U.S. independent producers threaten to undermine OPEC/NOPEC's restraint. To counter that threat, OPEC Secretary-General Mohammad Barkindo met with U.S. producers in Houston this week to discuss their common responsibility for market stability. In this note, we explain why OPEC and U.S. producers have no such common interest. Rather, shale producers gain revenue and market share if OPEC and NOPEC curb production to support higher prices. That leaves the cartel playing second fiddle to shale for fear of the economic consequences to its members of lower prices.

Unlikely and Impractical

In November 2017, OPEC and non-OPEC members agreed to continue their production agreement through 2018 to support prices. Recent pronouncements from cartel lead Saudi Arabia suggest the pact could continue into 2019 as members await confirmation that demand from an expanding world economy is soaking up new shale supply. The group seeks to maintain crude prices in a Goldilocks range somewhere between so high that they encourage conservation and new drilling and so low that cartel members can't finance their domestic spending programs. By talking to U.S. producers in Houston, OPEC hope to encourage some restraint among its rivals to prevent excess shale output from undercutting prices. We believe any such collusion is not only unlikely and impractical but also wouldn't benefit shale producers.

We begin by explaining why such action by shale producers is unlikely and impractical. Public and private U.S. oil production companies would be guilty of anticompetitive collusion if they signed up to participate in or in some way help the cartel to boost oil prices. Even if such a policy were to somehow bypass the legal obstacles, the practical logistics of carrying it out are probably insurmountable. There is no shale organization or U.S. trade group with the power to impose producer restraint.

Next—setting aside for the moment the impracticalities—we explain why any such agreement can't benefit shale producers.

Boom and Bust

Economics teaches that prices of vital commodities like oil are volatile during periods of scarcity as well as abundance. Prices pushed higher by scarcity, or the fear of scarcity, encourage a production boom that pushes prices lower by creating a surplus. This boom-and-bust cycle has existed as long as commodities have been critical to economic growth. Volatility in these cycles is a function of how quickly markets can respond to price signals. Whenever the surplus or scarcity overshoots, then volatility increases. Market participants can reduce volatility by improving transparency—publishing more accurate and timely fundamental data. The cycle can also be accelerated by faster producer response to scarcity and abundance signals. However, the random nature of conventional oil discoveries and the geopolitics of countries that own oil deposits have so far always resulted in short periods of extreme volatility.

Since price volatility makes the business of drilling for and producing oil very risky, it is no surprise that producers have historically sought to control supply to stabilize or increase prices. Such attempts have been relatively successful in reducing volatility over extended periods.

Railroad Commission Cartel

An early example is the producer cartel imposed by the Railroad Commission of Texas after the discovery of the massive East Texas oilfield in the 1930s. Faced with a flood of cheap oil, the state set up the Railroad Commission cartel to limit production, keep prices stable, and protect producers. This cartel worked for at least a decade but began to unravel when Texas producers found themselves propping up prices for, and losing market share to, overseas competitors with lower costs. Major oil companies realized they could import cheap and abundant Middle East oil into the United States at a profit so long as the Texas cartel propped up prices. The producer scheme became redundant once Texas output was so small that it was no longer relevant to the market.

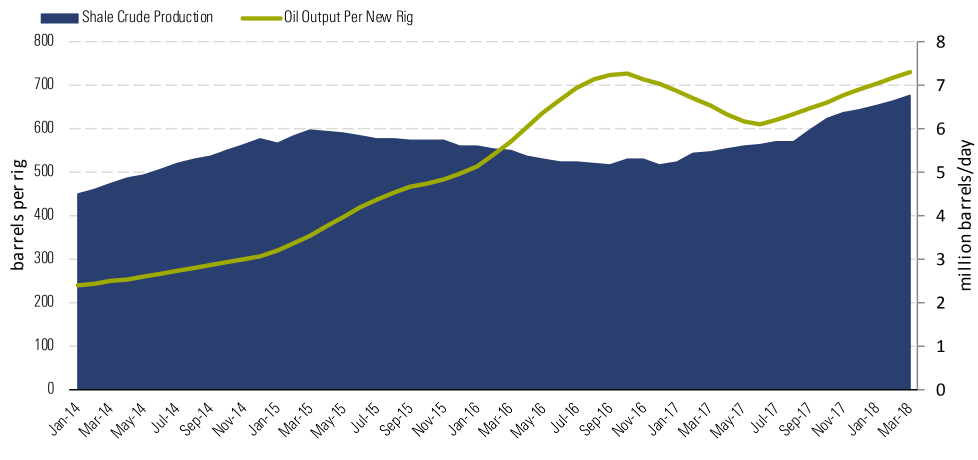
Later, the first OPEC accords in the 1970s pushed up prices for cartel producers but also encouraged more expensive discoveries, such as in the North Sea and Alaska, that later gobbled up market share. In both cases, the producer group restraint initially benefited members and then encouraged competitors to emerge and win market share from the cartel.

Historic Reversal

In the same way, the 2017 OPEC/NOPEC cartel came into being to push prices higher in an era when surplus crude output caused an oil price crash that threatened members' economic and political stability. Since that agreement came into force, U.S. producers have enjoyed resurgent growth and higher prices as a direct result of the cartel's efforts to rein in production. There is a certain irony that much of the U.S. production increase has occurred in the West Texas Permian Basin, allowing the Lone Star State—in a historic reversal of the 1930s—to blossom at the expense of the latest cartel's efforts.

Because U.S. producers benefit from the OPEC/NOPEC cartel's restraint, there can be no common interest between the two groups. Assuming that in a free market, producers will produce as fast and for as long as they can, then no individual U.S. producer is going to see the benefit of holding back its own output. Such a move would only benefit competitors and starve a producer of cash flow to repay investors. The reality is that we have seen continued increases in shale productivity and output since the end of 2016 after the U.S. rig count began to increase again in May of that year, according to the Energy Information Administration's Drilling Productivity Report (Exhibit 1).

Exhibit 1 U.S. Shale Productivity



Source: EIA, Morningstar

Nodding in Agreement

The worst part for the cartel is that it is now locked into the production agreement in the court of market opinion. Having made the commitment, it is obliged to keep to it. If it abandons the agreement, it encourages a free-for-all that threatens a new price collapse. As with previous producer agreements, the long-term benefits flow to nonparticipating competitors. Under the circumstances, with no incentive to join the cartel, U.S. producers probably see meeting in Houston for dinner and nodding in agreement about the need for restraint as a small price to pay for encouraging the cartel to keep up the good work on their behalf.

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