
U.S. and OPEC/NOPEC Cartel Won't Happen

No prospect of output agreement.

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Data Sources for This Publication

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Plea to Help Stabilize

The U.S. Department of Energy indicated on March 20 that it's sending a representative to Saudi Arabia to help that country and Russia return to a path of oil market stability. Then a Texas oil regulator held discussions with OPEC's secretary general. On March 24, G-7 finance ministers called for oil-producing nations to help stabilize the world economy, and the following day, the Trump administration urged Saudi Arabia to hold back on flooding the market. Taken together, these moves held out prospects of agreement among the world's top three oil producers — the United States, Saudi Arabia, and Russia — to limit production and arrest plunging oil prices. This note provides commentary on why such an agreement won't happen.

As we outlined in a March 2018 note ([Shale Holds Cards in OPEC's Houston Gambit](#)), U.S. crude producers have very different interests from those of the OPEC cartel and would make strange bedfellows now. That's because, as we explain below, shale producers have been the major beneficiaries of OPEC output cuts intended to support higher prices, and the shale productivity model doesn't lend itself to a production ceiling.

Shale Export Boom

A federal ban on overseas sales was lifted in December 2015, allowing U.S. producers to sell into the export market as shale output surged above refinery appetite for domestic crude. Refineries configured to process heavier barrels continue to import and consume medium- and heavy-gravity crude as excess incremental domestic light barrels seek markets overseas. Rising exports put U.S. producers directly into competition for market share with international rivals.

Shale output bottomed out after the last price crash at 8.6 million barrels/day in September 2016, according to the Energy Information Administration. Since then, U.S. producers drove production up 4.5 mmb/d in just over three years to 13.1 mmb/d in February 2020 and exports increased to average 3.0 mmb/d in 2019. That dramatic growth was supported by a combination of higher prices above shale break-even levels and an expanding overseas market absorbing the export barrels. Shale producers rely on productivity to keep costs down and improve investment returns. The model works well when initial production per well is rising, which encourages rapid production growth. In effect, the shale industry needs a combination of high prices and new markets to sustain growth.

Current Bust

Higher prices during this last round of shale expansion were supported by the OPEC and NOPEC agreement in place since November 2016, which placed a cap on the group's supply. U.S. sanctions against Iran and Venezuela also artificially removed market supply. These supply constraints created an opportunity for U.S. producers to expand market share at the expense of OPEC, NOPEC, and sanctioned suppliers while protected by higher prices. The opposite of this boom environment describes the current bust, since a sharp drop this month to below \$25/barrel for U.S. benchmark West Texas Intermediate has caused shale producers to slam on the brakes by slashing drilling budgets.

It's hard to imagine how the typically boom-and-bust shale model could operate within the confines of a production ceiling such as might be imposed by an output agreement between the U.S. and Saudi Arabia or other producers. Quite apart from the incompatibility of the shale model with an output ceiling, the breakup of the OPEC agreement in February points to deeper challenges within the cartel that would be hard to paper over.

Traditional OPEC

Members of the oil-exporting countries' cartel also sell into export markets, but their governments traditionally rely on oil revenue for basic income and their production costs are typically lower than shale. They use production flexibility to balance markets and keep prices high enough to finance their national agendas. This model works by controlling output to keep prices high, and it discourages new output until required by demand. Each member is expected to adhere to a quota, and they all benefit from higher prices, as long as they don't cheat. The model worked well for decades if the size of the overall market was expanding. Demand growth provided wiggle room for OPEC members that cheated on their quotas as well as for new production outside the cartel, financed by higher prices that encouraged new discoveries.

OPEC+

Russia joined forces with the cartel as the most significant partner signatory to the OPEC+ agreement in November 2016. This action served its short-term interest in supporting higher oil prices as well as its strategic interest in the Middle East. At first glance, this was a coup for OPEC because it was joined by the world's third-largest producer and arguably gained clout. However, the problem with this arrangement is that it clearly provided greater benefit to U.S. shale producers, which gained market share at the expense of their Russian rivals. Russian producers were prepared to tolerate the arrangement for a while but were always anxious to shift the heavy lifting on output cuts to Saudi Arabia. Any idea that Russia would cooperate better now with the U.S. seems far-fetched, with the latter having imposed ever-tighter sanctions on the former in recent years.

Breakup

The early March breakup wasn't a traditional OPEC dispute over output levels but rather a unilateral decision by Saudi Arabia to tear up its quota and flood the market. This may have been an attempt to bring Russia back to the table but could also signal the kingdom's frustration with the cartel. Some commentators suggest a new Saudi strategy to maximize market share at a low price that locks out competitors and secures higher revenue from volume sales. This makes sense and would align with plans to expand the role of recently privatized state oil firm Saudi Aramco by expanding downstream investment (see our September 2019 note [Saudi Exports Increasingly Tied to Downstream Investments](#)). Ultimately, the Saudis could be looking to their long-term future in a post-oil environment where production quotas have no meaning.

The acrimonious ending of the OPEC/NOPEC pact doesn't suggest either Russia or Saudi Arabia is ready to sign up for further restraint in the near term, no matter that low oil prices are hurting them. If Saudi Arabia's strategy now excludes the interests of other traditional OPEC members, then the group no longer has a central market role.

Not Practical

Into this context of the coronavirus crisis and plunging oil prices came suggestions last week that the Texas Railroad Commission and/or the U.S. Energy Department could meet with OPEC, the Saudis, and the Russians to agree to production restraint. Although meetings may take place, we believe they will be inconsequential and any such agreement won't benefit shale producers. Above all else, we don't believe any practical arrangement can be devised to herd independent shale producers into an output agreement. We outline our argument for this case below.

First, shale producers won't be easy to tie down to quota arrangements even if the necessary authority could be mandated. The consequences would be uneven across basins, producers, and midstream transportation companies. There would be logistic complexities dividing output quotas among producers, which would have to be managed at the state level.

The Texas Railroad Commission has been cited as potentially able to impose production limits. That precedent certainly exists because the commission performed this role between the 1930s and 1970s. But as we detailed in a note earlier this month ([New Mexico's Permian Shale Factory](#)), the largest oilfield in Texas, the Permian Basin, now produces significant volumes in New Mexico. That means any Texas quota would at best discriminate against producers across state lines and at worst encourage wholesale drilling migration to New Mexico. If a Texas quota increased prices, that would also encourage drilling in other basins like North Dakota and the Rockies with higher break-even prices, at the expense of more-efficient resources in the Permian.

While these consequences might be considered inconvenient compared with the wholesale loss of investment and jobs currently underway in the shale fields, they ultimately don't benefit consumers and raise the politically difficult specter of government-sanctioned higher gas prices in an election year.

Demand Destruction

So, expect oil prices to stay low for the rest of this year at least. The Russians may come back to the table with OPEC to try and bolster prices, but without Saudi support, any compromise won't have teeth. Meanwhile the coronavirus pandemic is destroying demand so rapidly—to the tune of at least 10 mmb/d, according to some estimates—that the depth of output cuts required to balance the market seems too daunting to contemplate. If Saudi Arabia continues to push for market share, then prices will sink lower as storage fills up.

Shale production will peak in a few months' time and then decline as drilling and completion dry up. U.S. crude exports will decline along with production, but weak domestic refining demand could still leave more barrels looking for overseas outlets. Excess crude will be stranded at the Gulf Coast in storage or heavily discounted to local refiners. Weaker producers will be bankrupted, and mergers and acquisitions will proliferate. A core set of the strongest shale producers will survive the downturn.

After the Storm

Once the coronavirus crisis is over, oil prices will be driven higher by recovering demand. Even though the Saudis and Russians boast their indifference to low prices today, they'll be unlikely to eschew higher revenue. When recovery comes, it will take a while to draw down teeming storage tanks. At some point, the strain on available supplies will push prices high enough to tempt surviving shale producers to emerge from hibernation and start the cycle again.

At that point, the challenge for U.S. producers will be attracting new capital from jaded investors for another round of drilling in the shale fields. The field will likely be left clear for majors like ExxonMobil, Chevron, and Shell to cherry-pick the best acreage to implement economies of scale for their industrial approach to output. ■■

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