



Market Meltdown: How OPEC Is Projected to Change

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In this ongoing five-part series on the global political and market impact of U.S. shale-derived hydrocarbons, the authors have described the rapid rise of shale, examined global and Asian demand trends for shale-sourced LNG from North America, and studied the prospects for continuing growth in shale extraction in the Trump era. In this fourth article for the series, they survey the varied response of oil and gas producers to the shale phenomenon, focusing particularly on moves by Russia and Saudi Arabia, including some potential areas of convergent interest with U.S. shale producers, but also assessing the OPEC cartel's direction and divisiveness.

Read Parts 1, 2, and 3 of the 5 part series.

As fallout over Jamal Khashoggi's murder continues, the U.S. – Saudi relationship may be facing its toughest test since the 1973 Oil Embargo. The world's largest crude exporter, and defacto leader of the Organization of Petroleum Exporting Countries (OPEC), is once again threatening to use its vast energy resources as political retribution, alluding to possible price spikes reaching \$200 per barrel (bbl) if foreign governments attempt to punish the Saudi regime for Khashoggi's murder. A Riyadh engineered oil price-spike seems less likely now given the recent downturn in oil prices, but the Kingdom's influence over energy markets should not be underestimated.

Taken at face value, the specter of retributive pricing complicates an already fraught energy relationship still further; lest we forget, the Kingdom over the past three years initiated and then led a brutal price-war against America's young shale industry. Yet for all that, the relationship is growing paradoxically both more contentious and more collaborative.

Despite the current diplomatic and PR brouhaha, an emerging convergence of geopolitical and geo-economic interests has become evident. Some industry analysts see the U.S. and the Kingdom – the world's two largest crude oil producers – more closely aligning their Three 'P' (political, pricing and producing) objectives in the coming months and years.

The overlap of mutual interest looks compelling. Both the United States and Saudi Arabia seek to contain Iranian power and fatally damage its regime. Both the US and the Kingdom are protective of their respective oil market share. Both see the best long-term benefit in stable, moderate oil prices. And between August and October of this year, oil prices seemed to be climbing at a dangerous pace – reaching their highest point since 2014.

To achieve the common aim of market stability, both understood that more oil needed to be pumped into the global economy, necessarily exerting downward pressure on oil prices. For the Trump administration, more oil production means cheaper gas at the pump in the run-up and aftermath to the 2020 November elections. For OPEC and its new group of non-member allies – which now includes Russia – moderate prices translate to locked-in demand, preventing consumers from investing in electric vehicles and alternative fuel sources.

More immediately, those with easily exploited spare capacity – the Russians and the Saudis – want more production and more revenue to eclipse competitors. By pumping now, both earn more revenues and protect the long-term sustainability of their petro-economies by increasing supply and keeping prices restrained. Pump too much, however, and fiscal budgets suffer. And as the United States learned the hard way, low oil prices can threaten the survival of a still nascent industry.

What room do US producers have in this calculation? The surprising answer – a Saudi/Russia/US axis in the oil markets. Here's why this makes sense:

David vs. Goliath

By the mid-2000s, North American shale producers had emerged as the wild-card disrupter of global oil markets. The combination of lower-up front capital expenditures (capex) and lightning-quick project completion times allowed US drillers to ramp up the amount of shale hydrocarbons extracted at an unprecedented pace. In a blink of a competitive eye, hydraulic fracturing made enormous strata of resource-bearing shale economically exploitable. Suddenly, the world's top oil consumer could contemplate a very large reduction in its reliance on imported oil.

Foreign producers watched all this very intently. Correctly perceiving a threat to market share, OPEC moved to stifle -- if not strangle outright -- the fledgling U.S. shale industry's merging impact on the global market. The Saudi-led strategy had a basic simplicity: Flood the world with low-cost crude and push oil prices down, thereby undermining the budding shale industry and prevent the US from recovering its mid-20th century oil market pre-eminence.

But this "drive 'em to the wall" strategy failed. By this past August, the US reached a daily output of 10.9 million barrels of oil per day (b/d), with unconventional shale responsible for 7.6 million b/d of that supply. The US Energy Information Agency (EIA) estimates that, earlier this year, the United States surpassed both the Russian Federation and the Kingdom of Saudi Arabia to become the world's largest producer of crude oil.

A rapidly tightening oil market pushed oil prices to a 4-year high, which brought with it talk of \$100/barrel once again. This uptick in prices was due in part to collapsing supply from Venezuela and Iran, and from associated geopolitical tensions for both these producers. For the time being it seems that this commodities cycle is winding down, with oil now heading back into the \$70 range thanks slowing global demand -- particularly in emerging markets.

OPEC is now feeling global pressure to uphold its mandate of preserving 'stable markets' and 'reasonable prices,' but the organization seems unwilling and/or unable to do so. Most analysts see OPEC's so-called "goldilocks" price range as falling between \$70 - \$90 per barrel. This comes high enough to meet the cartel members' fiscal breakeven threshold but doesn't reach price levels which would give decisive impetus to the accelerated development of renewable non-conventional energy sources. We can expect OPEC and its allies to fight to keep prices within this range -- a price window that is also amenable to Shale operators, who now enjoy an industry-wide break-even point below \$60 per barrel.

As usual, OPEC members quarrel with one another about production levels and price targets. The so-called 'price-hawks' (notably Iraq, Iran, and Venezuela) want the 1.8 million b/d production cut to which the cartel agreed back in November 2017. Others, fiscally less desperate, take a market-protection stance, arguing for production increases to prevent a collapse in demand, which would slap down prices again. One thing that all members can agree on, however, is that America's unconventional producers are encroaching on OPEC market share in Europe and in Asia.

Russia and Saudi Arabia -- representing two of the world's three most prolific energy producers -- now face a decision: should they double-down on a cut-price assault on North American shale, or, can they learn to live or even work with this new fixture of the global energy landscape?

The Rebirth of OPEC as 'OPEC-Plus'

Unlike the 1970s, the OPEC cartel today lacks the raw market-moving power it once had. Its fourteen-member nations nominally control about 35% of global oil output, and claim about four-fifths of all proven reserves.

This arithmetic is now changing, as the cartel pulls in non-OPEC states, including Russia, Kazakhstan, and Mexico. With the addition of seven other non-OPEC nations, the enlarged cartel's share of global production and reserves now stands at 55 and 90 percent, respectively.

How did this happen? In November 2016, OPEC members joined the most prominent non-OPEC producer states to initial a 'declaration of cooperation'. The composite group also created an 'OPEC/Non-OPEC Joint Ministerial Monitoring Committee' (JMMC).

Superficial analysis sees the resulting OPEC-Plus as new "super cartel." In reality, however, OPEC-Plus is simply a Saudi-Russian energy alliance, a way for the world's largest petrostates to bilaterally dictate oil policy while using the new and old cartel members as plausible deniability.

And while Russia and Saudi Arabia share few geostrategic goals, the advantages of a collaborative supply-growth approach over the past 6 months were too many to ignore.

Saudi Arabia: The Kingdom's greatest geopolitical rival is Iran. With U.S. energy sanctions now back in effect, the regime is facing declining demand for its exports, which have fallen from a high of 2.7 million b/d in April to around 1.7 million b/d this month. By increasing output, the Saudis put a downward pressure on prices and helped to make up for the supply shortfall, thereby depriving the struggling Islamic Republic of much-needed energy revenues (and negotiating power).

Increased production also served to protect Saudi Arabia's market share from competitors. While market rivals in North America and OPEC-Plus pump at full tilt, the Kingdom possess the largest spare capacity of any oil producing nation (purportedly capable of activating an additional 2 million b/d), meaning that every additional barrel of oil brought online displaces a barrel of competition.

Finally, lower oil prices support the enduring Saudi goal of guaranteeing long-term oil demand. As prices and volatility increase, consumers move to electric and hybrid vehicles, and increase investment in renewable energy sources. A well-stocked global supply of oil defends against fuel switching, thereby prolonging the Kingdom's economic future. Too far below \$70/bbl and we may see the Saudis reverse course -- cutting production to maintain the goldilocks price range. But for now increasing production has served them well.

Russia: With U.S. sanctions continuing to stunt Russia's economic growth, energy sales are a rare bright spot for the country's otherwise beleaguered economy. Oil and gas sales account for roughly 40% of Russia's federal budget revenues, and with crude prices pushing \$80/bbl, the government hauled in \$83 billion in energy sales this month -- a 50% increase over September of last year.

Despite a post-Soviet record high (of 11.36 million b/d), Energy Minister Alexander Novak recently indicated that an additional 300,000 b/d in spare capacity could be added quickly, if necessary. Indeed, Russia has increased its production by 389,000 barrels since May, and in October output is up 150,000 compared to the same time in 2017.

Russia has used its oil revenue windfall to insulate itself from the contagion currently sweeping through emerging markets. Increasing output to 11.5 million b/d and beyond would further bolster the Russian economy and simultaneously crowd out competitors. Even Iran, a longtime partner of Russia and consistent oil price hawk, is not safe from Rosneft's self-interest. For Russia, market share and financial gain have been two very good reasons to boost oil production. But like Saudi Arabia, Russia also needs a certain oil price to meet its budgetary needs. If the market continues on its current downward course, a collaborative production cut with Saudi is likely.

The U.S. Position

The current U.S. administration aspires for high domestic energy revenues and lower global oil prices. This is a winning combination for both U.S. energy security and those running for re-election. Increased pressure on the oil-dependent Iranian economy is a significant added bonus.

From the Oval Office, this means encouraging private operators – to the extent they can -- to produce as much as possible, while demanding the same of influential petro-states. Responding to rising oil prices, Trump leveled frequent accusations and threats against 'OPEC-Plus. The most recent diktat came last September, when he tweeted:

We protect the countries of the Middle East – they would not be safe for very long without us, and yet they continue to push for higher and higher oil prices!...The OPEC monopoly must get prices down now!"

Despite pumping a record 11 million b/d of crude (65% of which is onshore shale), the United States cannot unilaterally dictate global oil prices, particularly as mid-stream infrastructure constraints look to crimp shale growth. To achieve its goals, then, the administration must coerce or convince OPEC-Plus to play ball. Threats of dissolving U.S. defense ties and invoking NOPEC legislation suggest that this White House has, at least publicly, adopted a "Stick" approach thus far. But can there be a "Carrot?"

A Russia-Saudi-U.S. Axis of Convenience?

Whether deliberate or inadvertent, a triangular interest-based understanding about production levels have emerged between the Saudis, Russians and the United States. Together, these three energy giants constitute 1/3 of global oil supplies, meaning that any joint effort to affect energy market outcomes will be consequential.

Evidence of this marriage of convenience is emerging. Ahead of OPEC's annual World Oil Outlook conference held in Algiers this past September, Russia and Saudi Arabia met privately to outline a forward-looking production strategy. Front and center in the discussion were rising oil prices and Trump's attacks on OPEC-Plus.

At that meeting, Saudi Energy Minister Khalid al-Falih and his Russian counterpart, Alexander Novak, reportedly committed to lift output during the September-December period, in effect bowing to U.S. demand without consulting other OPEC-Plus members. Between May and October, the Kingdom has increased production by 530,000 b/d while Russia has boosted supplies by 389,000 b/d. The two show no signs of slowing.

The Russo-Saudi producer pact has three major implications for global energy markets:

First, Saudi Arabia and Russia have demonstrated a willingness and perhaps even a preference for bilateral consultation about oil output, as opposed to at least the pretense of conferring with other OPEC-Plus producers. Market-moving power flows from these two petrostates, which between them control a quarter of total world oil production: Saudi (10.7 million b/d) and Russia (11.3 million b/d). Working together, neither needs backing from lesser producers, OPEC or non-OPEC.

Second, while hydrocarbon extraction from shale has brought enormous benefits for American energy security, fracking cannot insulate the U.S. from the vagaries of global energy markets. Trump's appeal to OPEC to increase production and lower prices shows the persistent power of global oil producers. Shale does not confer energy autarky. In fact, its meteoric development also embeds us firmly in the world oil market, if only in ways that differ from earlier, import-dependent decades.

Third, the OPEC-Plus grouping seems willing, albeit furtively, to try to accommodate the U.S. administration on broad oil policy. Fear of repercussions over mounting oil prices are credible enough to spur a U.S.-conscious approach to output levels moving forward. Furthermore, all parties have a convergent interest in keeping markets adequately supplied, particularly as risks to the global economy continue to grow (among them the emerging market liquidity crisis and the prospects of a U.S.-China trade war). While the U.S. economy does benefit from lower oil prices, the high-growth Shale sector prefers that they not drop too low. We will have to see if U.S. operators follow Saudi and Russian moves to scale back their production in response to cooling global prices.

In a departure from recent history, the world's most notorious conventional producers have displayed a willingness to set aside their contempt for shale competitors and adopt a live-and-let-live relationship. More than that, emergence of convergent tripartite interests, the deterioration of Russia's fragile economy, and the Saudis' imperiled diplomacy with the US over the Khashoggi murder could bestow sufficient leverage for the US to push OPEC-Plus in directions promoting America's geostrategic goals.

It may still seem far-fetched, but we may be witnessing the emergence of a new de facto cartel, one steered by the US shale energy advantage. Stay tuned to see how Russia, Saudi Arabia, and U.S. producers respond to stabilize an oil market headed back to the doldrums.

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