Potential pitfalls to OPEC's latest agreement: Why it may not deliver a long-term price rise

(By Dr Scott Summers) After months of toing-and-froing in deliberations over output, OPEC members have finally reached an agreement that they can all agree upon. Production of oil will be reduced by 1.2 million barrels a day – down to a total of 32.5 million barrels a day – from January 1st 2017.[1] This agreement is only valid for six months; although, it may yet be extended for a further six months depending on the 'prevailing market conditions and prospects'.[2] The response from the market has been immediate, with a reaction similar to that witnessed in September, when OPEC first announced its plans to reduce supply.[3] After OPEC's announcement, US crude oil had increased by 9 % to $49.53 a barrel and Brent crude has swelled by 10% to $51.94 a barrel.[4]

This agreement was by no means a simple one for the OPEC members to reach. At one stage, cumbersome obstacles looked set to tarnish provisional negotiations between the cartel's three biggest oil suppliers – Saudi Arabia, Iran and Iraq – where concerns were raised over the reliability of data and potential exemptions to the deal.[5] Nevertheless, it seems Saudi Arabia has been willing to take the hit in terms of supply, as well as soften its position on Iran's request to raise its production to around 3.9 million barrels a day.[6] Moreover, and particularly in the light of this agreement, it has become increasingly evident that OPEC is abandoning its strategy of flooding the market with cheap oil in an

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[1] OPEC, 'OPEC Press Release – Agreement' (*OPEC*, 30 November 2016) <http://www.opec.org/opec_web/static_files_project/media/downloads/press_room/OPEC%20agreement.pdf> accessed 2 December 2016.

[2] ibid.

[3] Scott Summers, 'OPEC Seeks to Flex its Muscles on the Oil Market: Can it Still Influence the Price of Oil?' (*European Gas Hub*, 21 November 2016) <http://www.europeangashub.com/reports-presentations/opec-seeks-to-flex-its-muscles-on-the-oil-market-can-it-still-influence-the-price-of-oil.html> accessed 5 December 2016.

[4] BBC News, 'BBC News Market Data' (*BBC News*, 1 December 2016) <http://www.bbc.co.uk/news/business/market_data/commodities/143908/intraday.stm> accessed 1 December 2016.

[5] Nick Cunningham, 'Can Oil Markets Survive An OPEC Implosion' (*Oilprice.com*, 31 October 2016) <http://oilprice.com/Energy/Oil-Prices/Can-Oil-Markets-Survive-An-OPEC-Implosion.html> accessed 5 December 2016.

[6] OPEC (n 1).

effort to 'kill off' the US shale industry;[7] a strategy that has failed to deliver on its aims. OPEC is now willing to lose market share in order to see oil prices rise again.

Given that the agreement has already ushered in a steep rise in oil prices, OPEC will be hopeful that the deal is capable of facilitating elevated prices in the long-term. However, although it is likely that oil prices will continue to rise in the interim, a multitude of reasons suggest this rise will be short-lived. First, US shale producers will ramp up production as the price continues to rise and it becomes more profitable for them to extract shale oil.[8] Indeed, US President-elect Donald Trump has expressly supported a vision for expanding shale production in the US,[9] and intends to lift restrictions on shale reserves during his first 100 days in office.[10] He has pledged to 'unleash America's $50 trillion untapped shale, oil and natural gas reserves' and has – on numerous occasions over several decades – expressed his contempt for OPEC, stating that the US needs to 'become, and stay, totally independent of any need to import energy from the OPEC cartel or any nations hostile to US interests'.[11] It remains to be seen how these policies will be put into practice, but they suggest that the US shale industry is far from a spent force.

Second, at lot of the success of OPEC's latest agreement will depend upon other non-OPEC members accepting and adhering to the terms of this. The agreement document explicitly notes that the terms of the deal have been reached after 'extensive consultations…with key non-OPEC countries', most notably including Russia.[12] If these non-OPEC members fail to reduce production, or – in a worst-case scenario for the cartel – increase the production of oil, the effectiveness of the agreement will be diluted and

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[7] Scott Summers, 'OPEC and its Continuing Battle with US Shale Producers' (*Shalemarkets.com*, 2 June 2015) <http://www.shalemarkets.com/opec-and-its-continuing-battle-with-us-shale-producers/> accessed 4 December 2016.

[8] This is something which I have previously analysed in detail, see for example Scott Summers, (n 3).

[9] Donald J. Trump, 'An America First Energy Plan' (*Trump Pence*) <https://www.donaldjtrump.com/policies/energy> accessed 6 December 2016.

[10] Amita Kelly, 'Here is what Donald Trump wants to do in his first 100 days' (*National Public Radio*, 9 November 2016) <http://www.npr.org/2016/11/09/501451368/here-is-what-donald-trump-wants-to-do-in-his-first-100-days> accessed 5 December 2016.

[11] Trump (n 9).

[12] OPEC (n 1).

its overall success will be brought in to question. In practice, much will depend on whether the non-OPEC members are able to supply oil at the price levels we have observed in recent months whilst still making a profit. If they cannot, then they will have a greater incentive to reduce supply in order to achieve an increase in price in the longer term.

Third, the success of the deal could yet by jeopardised by the practical difficulties associated with controlling and policing cartel agreements. There is always an incentive for members to 'cheat' on the agreement because, in doing so, they stand to benefit from short-term gains in the form of increased profits (from the sales) and, potentially, a greater market share. For this reason, the internal governance of OPEC will be pivotal to ensuring that the signatories to the agreement play by the rules; a matter of particular note in light of the non-OPEC members involved in the agreement and the turbulent negotiations leading up to it.

Looking forward, it is likely that oil prices will stabilise over time, but we may have to wait until OPEC's next meeting, scheduled for 25th May 2017, for a first insight into how successful its new strategy has been. Nonetheless, as discussed above, there are a variety of factors that will affect and determine the success of OPEC's latest attempt to influence the price and supply of world oil. Yet one thing is very clear – if oil prices continue to rise, so too will interest in the exploration and extraction of oil going forward.[13]

[13] Scott Summers, 'Is the UK now open for Fracking?' (*Shalemarkets.com*, 27 October 2016) <http://www.shalemarkets.com/is-the-uk-now-open-for-fracking/> accessed 6 December 2016.