



Insight

OPEC Still Influences Oil Prices

PHILIP ROSSETTI | JUNE 25, 2018

Summary

- Despite huge increases in U.S. oil production, the combination of increased oil demand and artificial constraints on output through an agreement between OPEC and Russia, which together control more than half of global oil production, has forced prices to rise.
- Agreements to cut production, such as OPEC's, are often difficult to maintain as higher oil prices encourage nations to boost production, but falling production in Venezuela allows other OPEC members to boost production without exceeding the overall compliance targets.
- High oil prices encourage policymakers to act, but the best policy response is usually to do nothing: High prices on their own will incentivize increased non-OPEC production, improved efficiency, and fuel substitution.

Introduction

At an Organization of the Petroleum Exporting Countries (OPEC) summit last week, the cartel of petroleum exporters deliberated on whether to increase their oil output, eventually agreeing to increase total production by an assumed 600,000 barrels per day. As oil prices were relatively high most of that week, with Brent crude oil trading at \$75 per barrel, even President Trump was on the bandwagon [calling for OPEC](#) to increase its production.

The events of the past week show just how much power OPEC still holds over U.S. energy security, even though just two years ago the cartel seemed broken. As oil prices rise, the allure of government action to lower prices strengthens. Such action, while potentially attractive politically, would be policy folly, as it ignores the market dynamics at work when prices rise.

But I thought OPEC was dead...?

[Tales of OPEC's death](#) have been exaggerated. In late 2014, oil prices took a nose dive from over \$100 per barrel to lows that dipped under \$30 per barrel. Prices dropped initially because shale oil production in the United States caused U.S. oil production to double from around 5 million barrels per day (b/d) to 10 million b/d (and still increasing, recently [reaching 10.5 million b/d](#)). This massive increase threatened the ability of OPEC to manipulate prices. The cartel functions because member countries can raise prices by cutting output in a coordinated way, but the increased U.S. output reduced OPEC's overall market share, and thus their leverage.

The shale oil revolution meant the demise of OPEC, at least in theory.

In 2015, decisionmakers in Saudi Arabia saw a threat from the upstart U.S. producers and kept their oil output high, believing that a period of sustained low oil prices would force costly producers in the United States out of the market. Yet as shale producers in the United States proved exceptionally resilient even under low prices (due to rapidly improving productivity), Saudi Arabia—whose finances rely heavily on oil revenues—eventually caved and cut output to force a price increase. This output cut came in the form of the [2016 Vienna Agreement](#) among OPEC members and Russia. OPEC represents approximately 40 percent of the world's [crude oil production](#), and Russia around 13 percent. OPEC and Russia together controlled enough of global oil production that they could force a price increase by cutting output (a classic example of market manipulation by a cartel). In the 2016 agreement, OPEC and Russia agreed to cut their combined output by 1.8 million barrels per day.

Stability in an agreement like what came from OPEC and Russia in 2016 is often tenuous. When prices rise, participants have incentives to defect and claim more money by increasing output. When prices fall, oil-reliant nations still have incentives to defect because increasing production can alleviate revenue shortfalls. Yet instead OPEC was over-compliant and managed to keep under proposed production caps. U.S. production alone is not enough to keep up with rising demand ([1.65 million b/d per year](#)), and prices are consequently rising. Even the recent deal to increase OPEC output merely returns production levels to the agreed upon targets from 2016. How did OPEC manage to succeed in this?

The strength of OPEC's agreement has been aided by involuntary output cuts—mostly in Venezuela. The South American producer's output has slid from 2.2 million barrels per day in 2016 to a mere [1.4 million](#) barrels per day in 2018 due to the nation's inability to invest in productivity improvements as it struggles with political and economic crises. Venezuela alone represents 44 percent of the required output cut from OPEC. Elsewhere, conflict is [flaring up in Libya's oil crescent](#) and disrupting output, and President Trump's promise to reimpose sanctions on Iran threatens their oil sales on the market. Not to mention other crises in oil producing nations, such as Nigeria. The upshot is that major players in OPEC's market collusion have had to make relatively few changes to their output to meet production targets, making production caps easy to comply with. As a result, the United States—despite its huge output increase—is not entirely free of OPEC's influence.

Policy Solution: Patience

The lesson of the latest OPEC agreement is that the United States is not yet comfortably “energy secure.” Americans still care about OPEC because they still control enough of market production to influence prices. That means when the United States is interacting with foreign oil producers politically—such as sanctioning Venezuela, Russia, or Iran—it still must be cognizant of how those actions will affect domestic oil prices.

Policymakers today may be tempted to attempt to depress oil prices. In the past policies to control prices were tried, mostly unsuccessfully. During the oil crises of the 1970s, President Nixon implemented price controls on oil which lasted through President Carter's Administration. President Carter sought creation of a "[solar bank](#)." In 2005 and again in 2007, Congress enacted the Renewable Fuel Standard (RFS), a policy intended to replace petroleum fuel with ethanol (mostly from corn). All of these efforts have failed, with the RFS especially not only raising prices but also hurting incentives for domestic oil production more than those of foreign producers, [AAF has shown](#).

The latest proposed policy is a reconsideration of "NOPEC," an old legislative effort that would allow OPEC members to be sued by Americans for market manipulation. Until recently, U.S. presidents have always rejected NOPEC, as it would legitimize the efforts of foreign actors to sue the United States. President Trump is reportedly more amenable to the idea, but it is not entirely clear how, in practice, a U.S. court would extract court-awarded damages from a foreign government is not entirely clear.

The best policy, as time has shown, is to minimize government interference. As OPEC pushes prices higher, it creates incentives for other producers to enter the market. OPEC's "spare capacity" is [projected to decline](#), which shows a weakening of the cartel's ability to manipulate prices and force out risk-taking competitors. Higher oil prices also spur the consumption of alternative fuels, improvements in efficiency, and the substitution of equipment (e.g. electric vehicle adoption). High oil prices in the 1970s incentivized electricity producers to use less oil, and now America only gets [0.5 percent of its electricity](#) from petroleum. Reagan's lifting of price controls incentivized productivity and caused [oil prices to fall in 1981](#), and more recently high prices were what allowed U.S. oil producers to take risks with shale production techniques. Government subsidies or regulations won't break OPEC—the market will.

Conclusion

The continued ability of OPEC to influence global oil prices demonstrates that the U.S. economy remains far from immune to the influence of other oil-producing nations. Policymakers will continue to have incentives to focus on the near-term, but markets, as ever, hold much stronger incentives to diminish the power of cartels like OPEC, and that fact should be a guiding principle for any upcoming change in policy. Long-term energy security will require that government interventions do not undercut incentives for the private sector to improve productivity or reduce consumption.