

OPEC+ and Beyond: How and Why Oil Prices Are High

Written by Martin Beck

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MARTIN BECK, JAN 24 2019

On December 7, 2018, the so-called Vienna Group, the Organization of the Petroleum Exporting Countries (OPEC) under the leadership of Saudi Arabia and its partners, above all Russia, agreed to cut production in order to shore up oil prices. From a short-term political perspective, it is certainly remarkable that Saudi crown prince and de facto sole ruler Muhamad Bin Salman defied US President Donald Trump's preference for maintaining current production levels so soon after the American president had announced in a press conference held on November 20, 2018, that there would be relief of pressure on the Saudi strongman for his entanglement in the killing of the Saudi Arabian journalist Jamal Khashoggi. However, when applying a more fundamental view on the global political economy, what is actually of note is that, contrary to declarations of OPEC's death, as pronounced in the wake of the oil price decline in 2014 and beyond, the oil producers' cooperation has become a significant fact. After having peaked between 2011 and 2013 at above USD 100 per barrel, the average OPEC basket price dropped to below USD 100 in 2014 and even further to below USD 50 in 2015 and barely more than USD 40 in 2016 – but thereafter partially recovered. Production cuts as agreed upon among members of the Vienna Group in late 2016 contributed to a pickup of the OPEC basket price to above USD 50 per barrel in 2017 and USD 70 USD per barrel in 2018.

OPEC, which was founded in 1960 by Venezuela, Iran, Saudi Arabia, Kuwait, and Iraq, has had long-standing trouble maintaining a significant role in shaping oil prices for many reasons, among them the drop in the organization's global share in oil production. In the early 1980s, OPEC clearly lost its powerful position of producing around half of the global oil output; notwithstanding regaining some market shares since the second half of the 1980s, OPEC's share in global oil production was below 43 percent in 2017. With the formation of the Vienna Group, however, OPEC and its new allies now control above fifty percent of global oil production again, as Russia's output alone exceeds ten percent. Thus, the producers' cooperation, which aims at stabilizing a high price level by curtailing production through distribution of production quotas among its participants, regained power, as there were fewer producers outside OPEC that would respond to its production cuts by increasing their own (cf. Ratti and Vespignani 2015).

The remainder of this article aims to show that different popular assessments of recent developments in oil prices are insofar problematic as delineations of the effects of new technological developments and of market forces often lack sufficient complexity, and the role of oil producers, the relevance of their cooperation, and the significance of a gentlemen's agreement between the USA and Saudi Arabia are underestimated. It will be shown how and why oil prices, notwithstanding the recent ups and downs, are to be considered high if a market logic is applied. The outcome of an oil price that by far exceeds what would be market price is, albeit for very different reasons, in the interest of the two key players of global oil politics: the USA and Saudi Arabia.

Strengthening of the Oil Producers' Cooperation

The upward trend in oil prices in 2017 and 2018 was caused by different variables, among them socioeconomic and political factors such as the ongoing demise of the States of Venezuela and US President Donald Trump's decision to impose a severe sanction regime on Iran. Although owning 17.9 percent of proven reserves, Venezuela contributed only 2.3 percent to global oil production in 2017. When America announced its intention to impose a strict sanction regime on Iran in the framework of its withdrawal from the Iran nuclear deal in May 2018, this triggered an oil price increase because market participants expected decreased Iranian exports. However, there can be hardly

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any doubt that the resumption of the oil producers' cooperation was one factor, if not the most important one. In April 2016, a first initiative spearheaded by OPEC's dominant producer, Saudi Arabia, to establish a production quota system among OPEC members and major non-OPEC producers, *inter alia* Russia, failed due to the Saudi crown prince's orientation toward relative gains in the frame of the Saudi-Iranian rivalry, i.e. at that time he cared more to harm his adversary Iran than to yield his own potential benefits from higher oil prices. However, in November 2016, the Vienna Group, which is also commonly referred to as OPEC+, reached an agreement on significant production cuts in the Austrian capital, which became renewed in November 2017 and December 2018.

To Be or Not To Be a Cartel, This Is Not the Question Here

Jeff Colgan claims that for "those who recall its heyday in the 1970s, OPEC is a shadow of its former self." This assessment is based on several problematic presuppositions. In terms of effective impact on the global oil price, OPEC as an organization was much less important in the 1970s than thereafter. The oil price revolution of the 1970s was the combined result of market forces, the disintegration of American actors in the Middle Eastern oil sectors both on the level of states and private companies, and rather *uncoordinated* oil (nationalization) policies toward the Western oil companies in the Middle East, spearheaded by Libya and the Gulf monarchies (Schneider 1983: Chapter 4). Only in 1982 did OPEC introduce a production quota (Claes 2001: Chapter 4). This is often overlooked because, paradoxically, OPEC began to impact the market just when oil prices were in decline and then could 'only' prevent the oil price from plummeting even further. Furthermore, that OPEC managed in 2016 to do what it had so often failed to do when previously attempted – attract major non-OPEC oil producers such as Russia and Mexico – is another indicator of OPEC's vigor. Finally, Colgan's (2014) argument that OPEC is not a cartel and has no significant influence on global oil supply because cheating on quotas in OPEC is endemic overlooks that in a market economy it is in the nature of things that any attempt to establish a producers' cooperation runs the risk of being undermined by the its members cheating. Like any potential group of producers that aim at restricting production, OPEC – as well as the Vienna Group – is exposed to a prisoner's dilemma: Although all members are better off if the cooperative agreement lasts, each and every member has at any time a systemic incentive to exceed its quota. Cheating on production quotas has indeed been widespread in OPEC ever since its inception. Depending on the exact definition of a cartel, one may very well draw the conclusion that OPEC does not meet the criteria that would label it a successful cartel. However, concluding that cooperation is meaningless on the basis of notorious cheating in OPEC – and among members of the Vienna Group – is as valid as the argument that no such thing as a liberal trade order came into being after World War Two on the basis of the widespread attempts at protectionism thereafter.

As actors in a prisoner's dilemma have mixed motives whether to cooperate or not to cooperate, agreements on production quotas are in principle volatile. *Inter alia* in 1984, the OPEC quota system actually broke down (Alt, Calvert, and Humes 1988). This, however, does not exclude production control from regaining strength, as happened in November 2016, when Saudi Arabia enjoyed a de facto hegemonic role in OPEC due to the ongoing state crisis in Venezuela and managed to get Russia engaged in production control. Last but not least, the fact that Saudi Arabia, as OPEC's biggest oil producer by far, shoulders particularly high production cuts in absolute terms is per se not surprising, as it also benefits most from effective cooperation. One appropriate criterion for assessing whether a member of OPEC – and the Vienna Group – has a particularly high share in production cuts appears to be a high reserves-to-production ratio (R/P). If this criterion is applied, at the end of 2017, Saudi Arabia's R/P of 61.0 was clearly outweighed by OPEC members Kuwait (R/P of 91.9), Iraq (R/P of 90.2), Iran (R/P of 86.5), and even the United Arab Emirates (R/P 68.1). Although in some cases, such as that of Iran, a high R/P is a matter of political and technical constraints, in others, such as that of Kuwait, it is a choice. Thus, in relative terms, Kuwait's contribution to the success of the producers' cooperation is 'objectively' higher than Saudi Arabia's. An interesting question – the examination of which is, however, beyond the scope of this article – is whether Kuwait's particularly high R/P reflects pronounced solidarity with other producers or is an outcome of domestic decisions (such as preserving a bigger share of the oil in the ground for the well-being of future generations).

Are Current Oil Prices Low or High?

If compared to the oil-price level between 2011 and 2014, current oil prices are definitely low. Moreover, there is good reason to believe that this will remain so. Due to the availability of hydraulic fracturing, colloquially known as

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fracking,[1] the global supply of oil for production costs of around USD 55 per barrel is abundant, as shelf oil reserves have become commercial. Thus, a return to oil prices of USD 100 per barrel appears to be utterly impossible. In this light, even the upsurge of the OPEC basket price to a level of USD 70 per barrel in 2018 might turn out to be short-lived. On January 17, 2019, the OPEC basket price was indeed only USD 60 per barrel (OPEC 2019).

However, if current oil prices are historically contextualized, they do not at all appear as low. With the exception of the period between 1974 and 1985, the year 1990, and the periods 2004 to 2015 and 2017 to 2018, the average annual crude oil price since the end of World War Two has not been above a price range between USD 20 and 40 (adjusted to inflation for July 2017). Note that with the exception of the year 2016, all years past the 21st century high-price period 2011 to 2013 were years in which the price range between USD 20 and 40 was exceeded. As production costs in the Gulf peninsula are below USD 20 per barrel (Seznec 2008: 99), even USD 20 per barrel of crude oil as an average annual price, which since 1946 was undercut only in the year 1998, does not constitute a floor from a market perspective.

Production costs in the Middle East are many times lower than in the Americas, which are to a high degree determined by the rather costly technology of fracking. As the bulk of proven shelf oil reserves are located in the Western hemisphere, mainly in Venezuela, Canada, and the USA, there was an upsurge in proven reserves in the Americas from one fifth in 1997 to one third in 2007. Nevertheless, the current share of US proven oil reserves is only 2.9 percent as compared to Saudi Arabia's share of 15.7 percent. Still, during the year 2018, the USA overtook the production of first Saudi Arabia and then Russia to become the world's largest oil producer. It is nowadays common wisdom among oil experts that fracking prevents oil prices from resuming levels close to, not to mention above USD 100. What is, however, mostly overlooked is that the exorbitantly high market share of hydraulically fractured oil contributes to preventing the oil price from dropping to a level below USD 50 or even further.

Gentlemen's Agreement between the USA and the Gulf Monarchies

The fact that both the USA and Saudi Arabia contribute to high oil prices may be interpreted as a result of a tacit gentlemen's agreement between the financial interests of the Gulf States headed by Saudi Arabia and the politico-economic interests of the USA. The Gulf States and the USA agree to maintain the oil price on a level that keeps up the production of shelf oil by using the fracking technology commercially. The benefit for the USA is that it remains energy independent – in stark contrast to its Asian and European competitors. In turn, the Gulf States enjoy an exorbitantly high rent income due to the huge gap between global oil prices and the production costs of their oil fields. Moreover, Saudi Arabia as a country whose role in world politics would otherwise hardly outweigh that of the Vatican has managed to become a regional power with significant possession of global resources. In turn, the USA, albeit still a net importer of oil despite incorrect claims to the contrary, has been capable of avoiding oil dependence on the Middle East. Since the millennium, Saudi Arabia's petroleum exports to the USA have never reached the level of 2 million barrels per day (mbd); in 2017, imports from Canada reached a level of 4 mbd, whereas Saudi Arabia exported only 1 mbd of its overall exports of 7 mbd to the huge US market, which had an import volume of 10 mbd.

Summary and Outlook

Oil prices are kept high mainly due to the policies of two actors and their tacit interplay. The oil producers as organized in OPEC+ constrain their oil production. By doing so, particularly the Gulf States withstand market laws, as their production costs are very low. The reward for the producer states is exorbitantly high economic rents. Notwithstanding its relatively low reserves and despite high production costs, the USA produces high quantities of oil, thereby violating standards of a liberal market economy. The reward for the USA is that it has managed to (once again) become energy independent to a large extent. Another indicator of the tacit gentlemen's agreement between the USA and Saudi Arabia is that the latter leaves the American oil import market to a high degree to Canadian oil, which, like in the USA, is to a considerable extent a product of fracking.

The oil price will not fall below the production costs of shelf oil as determined by fracking as long as two features remain stable: the US preference for oil stemming from the Americas – US territory and Canada (as well as Venezuela) – and the Gulf States' willingness and capability to constrain their production (in coordination with non-

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OPEC members of the Vienna Group, mainly Russia) and not to further expand their capacities. Furthermore, the stability of the current global oil regime depends on the robustness of the alliance between Saudi Arabia and the USA. Riyadh lacks a viable alternative to its special relationship with the USA and must stick to it unless it is ready to risk its role in global politics. Thus, ultimately the stability of the American—Saudi oil alliance depends on the American preference for energy autarky. The alliance with Saudi Arabia paradoxically enables the USA to avoid dependence on Middle Eastern oil, thereby allowing it to maintain a hegemonic position among the states of the Global North in the crucial field of energy policy – in contrast to so many other fields in the global political economy.

The upper limit for the oil price is, in principle, its substitution costs, which are, however, very difficult to estimate. Yet, if one takes the 2018 average annual oil price of above USD 70 per barrel as a starting point, in the medium-to-long-term, potentials for downward factors seem to be rather high. The main reason for this is that at some point in the future, Libya and Venezuela might be capable of significantly increasing their production. Particularly Venezuela is potentially a crucial player because it possesses the highest proven reserves on a global scale since extraction from oil shelves has become commercial due to fracking. Moreover, there is no guarantee that the producers' cooperation in the Vienna Group will work indefinitely.

A great imponderable is whether and when a global energy revolution that terminates the dominance of fossil-fuel energies will occur. Yet, it is remarkable that in a recent study, the leading Saudi think tank KAPSARC (King Abdullah Petroleum Studies and Research Center) toyed with the idea that OPEC at one point in history may break down as a result of a significant decline in global oil demand.

Notes

[1] Fracking is a technology which was developed already in the 1940s. A mixture of water, sand, and chemicals is injected with high pressure into oil shale so it fractures in a way that enables the extraction of gas and oil. More recently developed combinations of horizontal drilling with hydraulic fracturing facilitated the exploitation of oil shale that was previously considered as commercially useless. So-called super fracking technologies could lower the level of oil supply costs even further to below USD 50 per barrel in the foreseeable future.

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