The Future of OPEC

In a world of low oil prices and fracking, is there still room for the cartel to flex its muscle?

For anyone old enough to remember the long lines at gas stations in the 1970s, the name “OPEC” still conjures images of an all-powerful cartel with the power to dictate oil prices to helpless consumers in the United States and around the world. Yet today, with the world awash in oil and prices mired in their longest slump in two decades, the 13-member Organization of the Petroleum Exporting Countries faces one of its greatest tests in its nearly 60 years of existence.

Though it still controls some 40 percent of global oil production and some 60 percent of the world’s exported oil, OPEC has lost much of its ability to impose prices, says Greg Priddy, director of global energy & natural resources for the global risk consulting firm the Eurasia Group. Facing a protracted slump in oil prices, in November 2016, the cartel agreed on its first production limits in eight years, in an attempt to raise prices. With suddenly abundant U.S. shale oil threatening to swamp OPEC attempts to control supply, there’s no guarantee the agreement will work – and no sign yet that oil prices are rising.

To gain some clarity around these issues, OUTLOOK spoke with Priddy about the cartel’s ongoing relevance, how it makes decisions and what it hopes to achieve, and where oil prices may be headed next.

OUTLOOK: What are OPEC’s current aims regarding oil prices?

Greg Priddy: OPEC’s six-month production-cutting agreement, signed last November and rolled out in January, was an attempt to deal with the global oil glut that has depressed prices since 2014. Their hope is that by cutting production they can reduce the excess global inventory and bring prices back into equilibrium – somewhere in the low 60s.

OUTLOOK: Will that work? Where do you see oil prices going over the next several months?

GP: I expect that the dollar-per-barrel price of oil will remain somewhere in the 50s for most of this year, which means that Americans can expect to fill their tanks for about what they’re paying now, with some seasonal adjustments. Prices generally go up in the summer.
This Month’s Expert

Greg Priddy covers the world oil industry as director of global energy and natural resources for the Eurasia Group, a global political research and consulting firm. His areas of expertise include market disruptions, sanctions policy, resource nationalism, OPEC cartel politics, environmental regulation, and demand management.

Priddy earned his bachelor’s and master’s degrees in international affairs from the Elliott School at George Washington University, and studied at the American University in Cairo. Before joining Eurasia Group in 2006, he spent seven years at Z, Inc., a Washington-based consultancy, covering international and supply risk issues as a contractor for the U.S. Energy Information Administration.

OUTLOOK: So is it fair to say that the production limits haven’t been successful?

GP: They’ve probably succeeded in the sense that prices haven’t dipped back into the $40 range. But getting to that point of equilibrium – a stable, supportable price based on the cost of getting oil out of the ground, the cost of capital, demand, and other factors – is no easy proposition, and many questions remain.

OUTLOOK: What are the key questions that OPEC is facing right now?

GP: First is whether they can keep their own membership in line. Iraq has more or less complied, but they’re investing in future production in a way that indicates they plan to increase production in the second half of the year. Indonesia, which chose not to go along with the agreement, has suspended its OPEC membership as a result. Then there are non-OPEC countries like Russia, which agreed to cooperate but has done less than half of what they agreed to do.

The next big question is whether OPEC will extend its agreement, which expires in June, for another six months. If they don’t, prices could drop. But if they do, and prices rise too rapidly, there’s always the chance that U.S. production will ramp up and fill the void, resulting in another glut. One alternative OPEC is considering is a three-month extension, which would be kind of splitting the difference between those two risks.

OUTLOOK: In general, how much control has OPEC had over global oil supplies and prices since the organization was founded in 1960?

GP: Their influence has waxed and waned. There have been periods when OPEC was able to essentially define whatever price level they wanted and drive prices above the equilibrium I described, more or less at will. Their heyday was the 1970s and early 1980s, beginning with the Arab embargo of 1973 and ’74, when global oil prices jumped to a new plateau, running through events such as the Iranian revolution and the Iran-Iraq war. That heyday came to an end in the mid-1980s, when U.S. vehicles started to become more fuel-efficient. Lower demand made it much harder for OPEC nations to elevate prices by cutting production, and the price of oil dropped fairly dramatically.

That cycle was in some ways similar to the one we’ve seen in recent years: A period of escalating prices giving way to a steep decline.
The way the technologies have evolved, there’s much less overlap these days in how oil, coal and natural gas are used – and hence the prices aren’t linked the way they once were.”

**OUTLOOK: What drove the current decline? As recently as 2014, many Americans were paying $4 or more per gallon to fill their tanks.**

**GP:** In a few words: The U.S. shale boom. The oil industry has known for decades that there’s a lot of oil in American shale. But because it’s trapped in narrow seams between layers of rock, most people assumed there would never be a way to extract it at a break-even cost below $70 or $80 per barrel. Today, thanks to rapid improvements in fracking technology, it’s not uncommon for high-quality shale oil to break even at $40 a barrel.

Though the boom started in earnest around 2011, it took a few years for the impact to be felt in prices, in part because of geopolitical events such as U.S. and European sanctions on Iran, the Arab Spring, and the civil war in Libya. These disruptions limited or threatened to limit global production and helped keep prices above $100 per barrel. Eventually, the day of reckoning arrived. Growth in U.S. production reached the point where you had this massive oversupply of oil on the global market. Prices collapsed in the middle of 2014 and have yet to recover.

**OUTLOOK: What impact has the shale boom had on OPEC’s influence?**

**GP:** The biggest change is the speed with which U.S. producers can move to fill gaps in the global market. The time lag for shale production to respond to price signals is five or six months. Before, it took producers a couple of years. This large amount of short-cycle supply makes it much more difficult for OPEC to dictate prices for any length of time.

**OUTLOOK: The shale boom has also unleashed lots of natural gas, and President Trump has vowed to revive the coal industry. To what extent do these fuels affect the price of oil?**

**GP:** The way the technologies have evolved, there’s much less overlap these days in how oil, coal, and natural gas are used – and hence the prices aren’t linked the way they once were. Coal is mostly for power generation. Natural gas and oil used to be much more closely linked, when more oil was used for generating electricity and heating buildings. Oil still heats some buildings, particularly in the northeastern U.S., but that’s waning, and there’s very little oil-fired power generation anymore.

**OUTLOOK: Outside of limiting production, what other means does OPEC have to raise or maintain oil prices?**

**GP:** None. That’s the only thing they can do. However, they do have certain advantages when it comes to production costs. For all of the improvements in fracking technology, extracting oil in the traditional way from wells remains much cheaper. Though the Saudis don’t publish their finances, their costs are probably around $8 to $10 a barrel, which gives them significant flexibility on pricing.
**OUTLOOK: How does OPEC reach agreements, and how does it enforce them among member nations?**

**GP:** In theory, they operate by consensus. No official OPEC agreement goes out unless all the ministers sign off. That’s not easy to attain, which is one reason last November’s agreement was the first one they’ve had in eight years. In this agreement they referred to the production cuts as “targets” rather than quotas (which was a term they used in the past) and limited the agreement to six months, from January through June. On May 25, they’ll meet to discuss whether to extend the deal.

All of this speaks to the difficulty in enforcing agreements. OPEC is an international organization of sovereign nations. It can’t take violators to court. The only real means of coercion is the fear that if the agreement doesn’t hold, prices will go lower, which hurts everyone. That said, these problems aren’t new, and compliance with the current agreement has been good by historical standards. The Saudis have cut a little bit deeper than what they agreed on, while some countries have only partially complied. It’s not perfect, but it’s a solid alliance.

**OUTLOOK: Saudi Arabia is generally considered the de facto leader of OPEC. Why does it hold that status?**

**GP:** It’s by far the largest producer among the member nations, with a capacity of 11 or 12 million barrels per day. Iraq, with the second-highest capacity in OPEC, can produce less than 5 million. There have been times, such as the mid-1980s, when the Saudis have deliberately cut production almost to the level of some other OPEC countries. But their enormous capacity means they have unparalleled power to ratchet up and ratchet down at will. That gives them a unique role. While Saudi Arabia can’t unilaterally impose production limits on other countries, OPEC has never taken a pricing action without the Saudis’ full support.
OUTLOOK: Do you expect an impoverished OPEC member such as Venezuela, which desperately needs revenue, to produce as much oil as they can, as fast as they can?

GP: Venezuela, surprisingly, hasn’t violated the latest OPEC limits. In fact, their production has been declining. What’s less clear is whether that reflects voluntary compliance with the November agreement or the fact that because of the country’s economic and political crises, there’s now little investment in any Venezuelan industry, including oil production. I think the bulk of their decline has to do with the latter.

OUTLOOK: What about Iran? Are they the “problem child” of OPEC?

GP: Iran was certainly a big sticking point last June, when OPEC first tried, unsuccessfully, to agree on limits. Iran was still recovering from four years of U.S. and European economic sanctions, which ended with the Iran deal in January 2016. They were in no position to cut back. Even when OPEC finally did agree on limits in November, Iran simply agreed to cap production at about 3.8 million barrels per day – which is all they’re capable of producing right now. The Saudis, by contrast, took sizable cuts, as did some others.

But Iran certainly doesn’t see itself as a problem child. If anything, they feel the Saudis stole market share from them during the sanctions. Iran will likely be looking to increase its production in the future, to regain what they see as their rightful market share. So getting them to go along with future cuts won’t be easy.

OUTLOOK: Considering how critical President Trump has been of the Iran deal forged under President Obama, what are the chances the deal will be reversed, with new sanctions on Iran?

GP: Our view is that the Iran deal is solid and will hold together. There is some risk, of course, but the market is definitely not pricing in the idea that it’s going to fall apart.

OUTLOOK: With all of the changes in the global oil situation over the past few years, what do you see as the long-term viability of OPEC as an organization?

GP: Though there are no guarantees, I think OPEC will remain in business. Even though it is no longer possible for them to defend the price above the equilibrium for any length of time, the cartel remains relevant as a rational response to recessions. When there’s a sudden drop in demand or surge in supply, OPEC’s ability to jointly limit production helps absorb some of that blow.
OUTLOOK: What if they were to disband? What would that mean for member nations?

GP: Some of the countries would have to make painful, long-term adjustments. But it wouldn’t necessarily be a catastrophe. In fact, some have already begun adjusting to an extended period of lower prices. Even Saudi Arabia has started reducing subsidies for gasoline consumption among its own population. A lot of things that people were used to getting for free or for a nominal price, they’re now paying close to market rates for. They’ve also been cutting state salaries, taking away bonuses, and tightening their belts in other ways. The Saudis have an ambitious plan, called Vision 2030, for transitioning to a more diversified economy.

OUTLOOK: Is OPEC’s continued existence essential to political stability in the Middle East?

GP: I don’t think oil price behavior has really driven conflict or lack of conflict in the Middle East. When you look at the rise and fall of tensions in the region, what’s going on in Yemen or in Syria, for example, oil has not been central to that. So it’s not clear that an end to OPEC would lead to serious political conflicts.

OUTLOOK: Some observers say we’ve turned a corner to a new era of low oil prices forever – or, at least, for the foreseeable future. Do you agree?

GP: I think low prices will be in place for some time. But words such as “forever” don’t apply to the oil industry. If you go back historically and look at 10-year price forecasts, more often than not, they turned out to be wrong. Usually that’s because some unforeseen technology or economic change came along on the supply side or the demand side.

It could be something like shale, or Americans buying small cars with fuel-injected engines in the early ’80s, both of which led to price declines. Or it could be something like the rise of China and other emerging markets during the 2000s, which helped drive a surge in demand and had everyone talking for a while about a new era of higher prices. Whatever you predict, something is going to take your prediction off track. When I started my career in the ’90s, the conventional wisdom was that the price of oil was going to be $20 a barrel for the foreseeable future. That was something that almost everyone believed – and look at all the twists and turns we’ve witnessed in the past 20 years. The one certainty is that there are more changes ahead.
Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 3/31/17. They are intended to provide rate or cost indications only and are for notional amounts in excess of $5 million except for forward fixed rates.

KEY ECONOMIC INDICATORS

Gross Domestic Product (GDP) measures the change in total output of the U.S. economy. The Consumer Price Index (CPI) is a measure of consumer inflation. The federal funds rate is the rate charged by banks to one another on overnight funds. The target federal funds rate is set by the Federal Reserve as one of the tools of monetary policy. The interest rate on the 10-year U.S. Treasury Note is considered a reflection of the market’s view of longer-term macroeconomic performance; the 2-year projection provides a view of more near-term economic performance.

ECONOMIC AND INTEREST RATE PROJECTIONS

Forecasts courtesy of Bloomberg and Blue Chip Economic Indicators

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US Treasury Securities

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FORWARD FIXED RATES

A forward fixed rate is a fixed loan rate on a specified balance that can be drawn on or before a predetermined future date. The table below lists the additional cost incurred today to fix a loan at a future date.

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<th>Forward Period (Days)</th>
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<tr>
<td>365</td>
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Costs are stated in basis points per year.

RELATION OF INTEREST RATE TO MATURITY

The yield curve is the relation between the cost of borrowing and the time to maturity of debt for a given borrower in a given currency. Typically, interest rates on long-term securities are higher than rates on short-term securities. Long-term securities generally require a risk premium for inflation uncertainty, for liquidity, and for potential default risk.

IMPLIED FORWARD SWAP RATES

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<th>Years Forward</th>
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<th>1-year Swap</th>
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3-MONTH LIBOR

This graph depicts the recent history of the cost to fund floating rate loans. Three-month LIBOR is the most commonly used index for short-term financing.

TREASURY YIELD CURVE

The yield curve is the relation between the cost of borrowing and the time to maturity of debt for a given borrower in a given currency. Typically, interest rates on long-term securities are higher than rates on short-term securities. Long-term securities generally require a risk premium for inflation uncertainty, for liquidity, and for potential default risk.
On March 29, CoBank President and CEO Tom Halverson testified before Congress at an oversight hearing on the Farm Credit System and the critical role it plays supporting the U.S. rural economy.

“CoBank’s customer-owners are in capital-intensive industries,” Halverson told the House Committee on Agriculture. “They need reliable access to credit, regardless of market conditions. We have focused on building financial strength to ensure our reliability.”

Halverson was one of three witnesses from individual Farm Credit institutions called to speak on behalf of Farm Credit before the committee. Also appearing were Jimmy Dodson, board chairman for Farm Credit Bank of Texas, and Doug Stark, CEO of Farm Credit Services of America in Omaha and Frontier Farm Credit in Manhattan, Kansas. In addition, the committee heard testimony from Dallas Tonsager, chairman of the Farm Credit Administration, the System’s independent regulator, and Jeff Hall, another FCA board member.

The hearing was called by U.S. Rep. Mike Conaway, R-Texas, who chairs the Committee on Agriculture. The committee and its counterpart in the U.S. Senate have jurisdiction over the Farm Credit System, which today accounts for approximately 40 percent of farm lending nationwide.

Halverson and the other witnesses spoke about the unique role the System plays in supporting agriculture and other rural industries. They noted that, as cooperatively structured lenders owned by their borrowers, Farm Credit banks and associations will always stand by their customers.

“Farm Credit’s key value proposition is dependability,” Halverson said. “We stand by our customers in good times and difficult times. That includes conditions like today, when downward pressure on commodity prices impact farmers, ranchers, and co-ops. We are monitoring credit quality carefully and working closely with our customers to ensure their access to credit required to manage successfully through this difficult period.”

CoBank’s infrastructure loan portfolio, which provides financing for rural providers that deliver power, water and communications services to rural communities, now exceeds $20 billion, with customers in all 50 states. Halverson said those industries form “the backbone of the U.S. rural economy” and that “our mission is to provide them the credit they need.”

About CoBank
CoBank is a $126 billion cooperative bank serving vital industries across rural America. The bank provides loans, leases, export financing and other financial services to agribusinesses and rural power, water and communications providers in all 50 states. The bank also provides wholesale loans and other financial services to affiliated Farm Credit associations serving farmers, ranchers and other rural borrowers in 23 states around the country.

CoBank is a member of the Farm Credit System, a nationwide network of banks and retail lending associations chartered to support the borrowing needs of U.S. agriculture, rural infrastructure and rural communities. Headquartered outside Denver, Colorado, CoBank serves customers from regional banking centers across the U.S. and also maintains an international representative office in Singapore.

For more information about CoBank, visit the bank’s web site at www.cobank.com.