Economic Update

ENERGY

Federal Reserve Bank of Dallas

OPEC Extends Cuts, Opening Door for U.S. to Gain Further Market Share

Fourth Quarter 2017

OPEC and some non-OPEC countries have agreed to extend their output cuts through next year despite losing market share. Crude oil prices have increased roughly 15 percent over the fourth quarter on the back of geopolitical turmoil in the Middle East and in anticipation of the agreement. This provides incentive to a U.S. energy industry that is gaining momentum in ramping up oil production.

OPEC's Meager Results

OPEC and non-OPEC countries agreed to extend cuts of 1.7 million barrels per day (mb/d) for another nine months, from March to year-end 2018, broadly in line with market expectations. OPEC has sold its agreement as a success, citing declines in Organization for Economic Cooperation and Development (OECD) inventories above the five-year average. A closer look suggests that OPEC's success story is in fact far more muted.

On paper, OECD inventories above the five-year average have fallen roughly 50 percent since the start of OPEC's cuts in December 2016. However, only half of this decline represents actual inventory draws. The remainder is due to changes in the computation of the OECD inventory five-year average, which has been shifted upward since 2016. The new five-year average includes 2017 inventory data and is therefore higher (*Chart 1*).

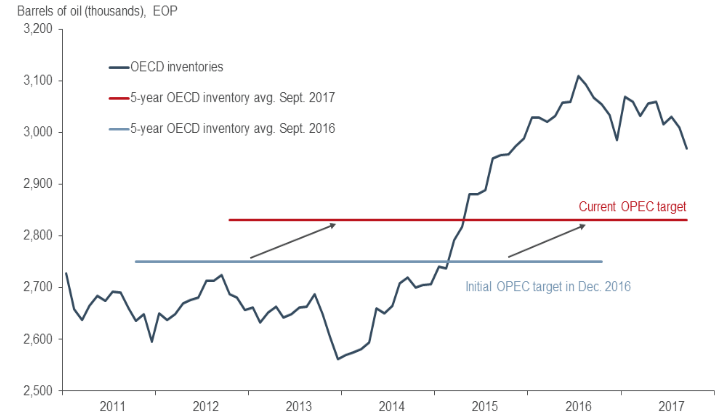
Additionally, OECD inventories provide only a limited picture of changes in global inventory. While OECD inventories declined by about 100 million barrels (mb) from third quarter 2016 to third quarter 2017, Chinese inventories increased by about 200 mb. This suggests that OECD inventory declines perhaps only reflect a shift in inventory from OECD to non-OECD countries (*Chart 2*).

The future of the agreement is uncertain as well. First, the cuts will be reevaluated in June 2018, essentially limiting the effectiveness of the extension to three months. Second, Russia has a presidential election in March and the Russian government might reconsider its support of the cuts afterward. OPEC needs the participation of Russia and other non-OPEC countries because it has lost monopoly power due to higher elasticity of supply from shale oil.

OPEC Losing Market Share

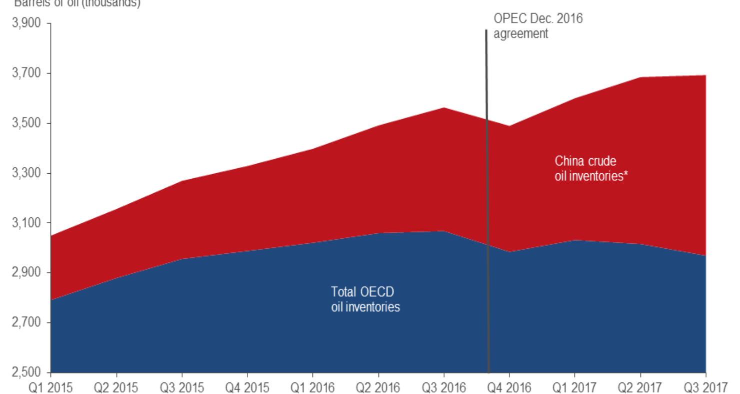
The production cuts come at a cost to OPEC. The cartel has lost about 1 percentage point of market share since its initial agreement to cut output in December 2016. U.S. crude output has rebounded and gained 1 percentage point over the same time (*Chart 3*). These shifts in market share are expected to continue in

Chart 1
OPEC Chasing Upward-Moving Inventory Target



NOTES: OECD is the Organization for Economic Cooperation and Development; EOP denotes end of period.
SOURCES: International Energy Agency; Federal Reserve Bank of Dallas.

Chart 2
Inventories Shift from OECD to China



*Estimates include the Strategic Petroleum Reserve.
NOTES: OECD is the Organization for Economic Cooperation and Development; OECD inventories include crude oil and petroleum products.
SOURCES: International Energy Agency; Federal Reserve Bank of Dallas.

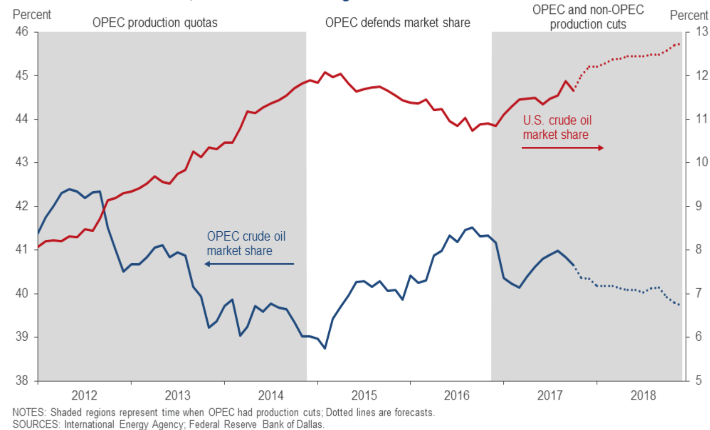
2018, based on data from the International Energy Agency (IEA) and the assumption that OPEC crude oil production will remain constant at 32.5 mb/d.

Even if OPEC continues its agreement in June 2018 and keeps compliance at the current high rate, the IEA expects on average no global inventory drawdowns next year (*Chart 4*). This implies that OPEC will head into 2018 with unease about the effectiveness of its action.

U.S. Producers Getting into 'Manufacturing Mode'

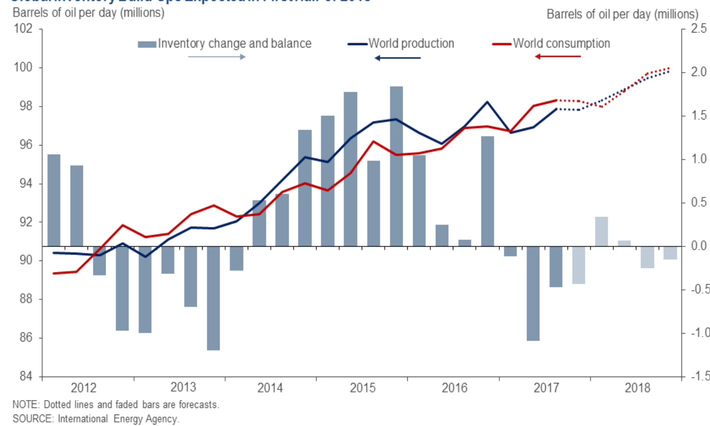
While OPEC extended its cuts, U.S. shale producers have continued to ramp up their production. Exploration and production firms have strongly increased their hedging activities, supporting future output growth. The IEA expects U.S. crude oil production to increase on average by

Chart 3
Market Share Falls for OPEC, Rises for U.S. Following Cartel's Production Cuts



NOTES: Shaded regions represent time when OPEC had production cuts; Dotted lines are forecasts.
SOURCES: International Energy Agency; Federal Reserve Bank of Dallas.

Chart 4
Global Inventory Build-Ups Expected in First Half of 2018

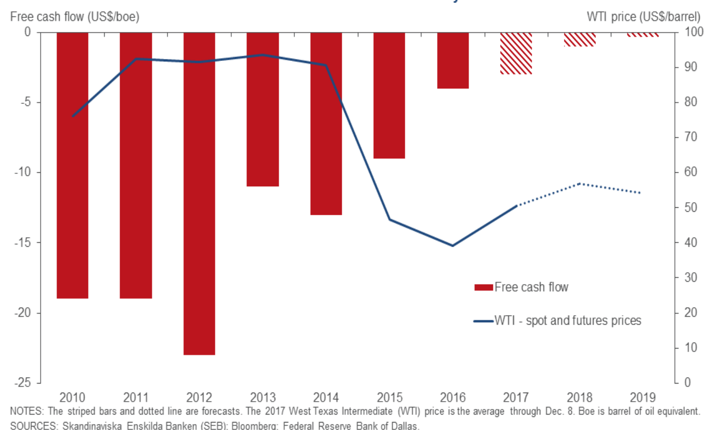


NOTE: Dotted lines and faded bars are forecasts.
SOURCE: International Energy Agency.

Chart 5
U.S. Crude Production and Rig Count Slightly Up

NOTE: The dotted line is a forecast.
SOURCES: Baker Hughes; International Energy Agency.

Chart 6
U.S. Shale Oil and Gas Producers Move Closer to Cash Flow Neutrality



NOTES: The striped bars and dotted line are forecasts. The 2017 West Texas Intermediate (WTI) price is the average through Dec. 8. Boe is barrel of oil equivalent.
SOURCES: Skandinaviska Enskilda Banken (SEB); Bloomberg; Federal Reserve Bank of Dallas.

0.9 mb/d in 2018. The U.S. oil rig count started rising again in November, and U.S. crude oil production growth rebounded as well from declines due to hurricanes Harvey and Nate (*Chart 5*).

U.S. shale producers are getting closer to positive cash flow (*Chart 6*). This seems to be driven by pressure from investors and by the industry's transition from a growth to a "manufacturing mode." This means that production is becoming more standardized and extracting oil from the ground more predictable. Larger companies can take advantage of economies of scale and advanced technologies.

Downside Risk to Prices

Oil prices have increased 15 percent since the end of third quarter 2017, reflecting geopolitical turmoil in Saudi Arabia and Iraq, and the extended OPEC agreement. Industry contacts expect prices to stay at current levels or decline in the next year. Most believe that global markets will be oversupplied in 2018.

—Grant Strickler and Martin Stuermer

About the Authors

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