

OPEC'S Market Role: Changing Signs?



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Summary of OPEC's Historical Market Role

- Restrict production to elevate price above competitive level.
 - 1974-1982: Fixed posted price with agreed differentials
 - 1982-2014: Official production quotas with member allocations
 - 2015-2016: Abandon quotas: Maintain OPEC market share despite falling price
 - 2017-2018: Return to official production quotas, include Russia, etc.
 - 2018- : ???

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- Slow development of incremental production capacity, to alleviate “cheating.”
(If they have it, they’ll use it).
- Hold and manage spare capacity to offset shocks and dampen price volatility.
(Pierru, Smith, and Zamrik, forthcoming in *The Energy Journal*)

Defense of the Market Share Strategy

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-- M. A. Adelman, 1992

“Deja Vu All Over Again,” *Energy Journal*, vol. 36, Special Issue 1, 2015

More Defense of the Market Share Strategy

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-- Thomas Stauffer, 1994

“OPEC prices and non-OPEC oil production: Survivors and casualties of the ‘market share’ strategy,” *OPEC Bulletin*, vol. 25, No. 4

ALESSI BALSAMIC VINEGAR



Available in My Local Market

Alessi Balsamic Vinegar (Modena, Italy)

- A. Aged 4 years in wood **\$3.69** /bottle
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Sell More Now... or Save for the Future?

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Seller's Indifference:

$$\mathbf{\$3.69} = \mathbf{\$12.99 / 1.08^{16}}$$

Current Sale = Present Value of Future Sale

Available in the World Oil Market?

Saudi Arabian Light Crude Oil (Persian Gulf)

- A. Sell Now (2015 spot) **\$100** /bbl
- B. Sell Later (save until 2050) **\$1,400** /bbl ???

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Seller's Indifference:

$$\mathbf{\$100 - \$5} = (\mathbf{\$1,400 - \$5}) / 1.08^{35}$$

$$\mathbf{Current Sale} = \mathbf{Present Value of Future Sale}$$

Does \$60/Barrel Pass the Long-Run Test?

Saudi Arabian Light Crude Oil (Persian Gulf)

- A. Sell Now (2017 target) **\$60** /bbl
- B. Sell Later (save until 2050) **\$700** /bbl ???

Seller's Indifference:

$$\mathbf{\$60} - \$5 = (\mathbf{\$700} - \$5) / 1.08^{33}$$

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Mostly **favorable** impacts,
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How Do High Oil Prices Impact OPEC?

Short-Run

Mostly **favorable** impacts
due to demand and supply reactions (higher oil prices).

The Long-Run has arrived. It does not include high prices.

Mostly **negative** impacts,
due to demand and supply reactions (stranded assets).

How Do High Oil Prices Impact OPEC?

Short-Run

OPEC will still defend the price... at a lower level.

due to

Long-Run

The Long-Run has arrived

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A Lesson Learned Too Late?

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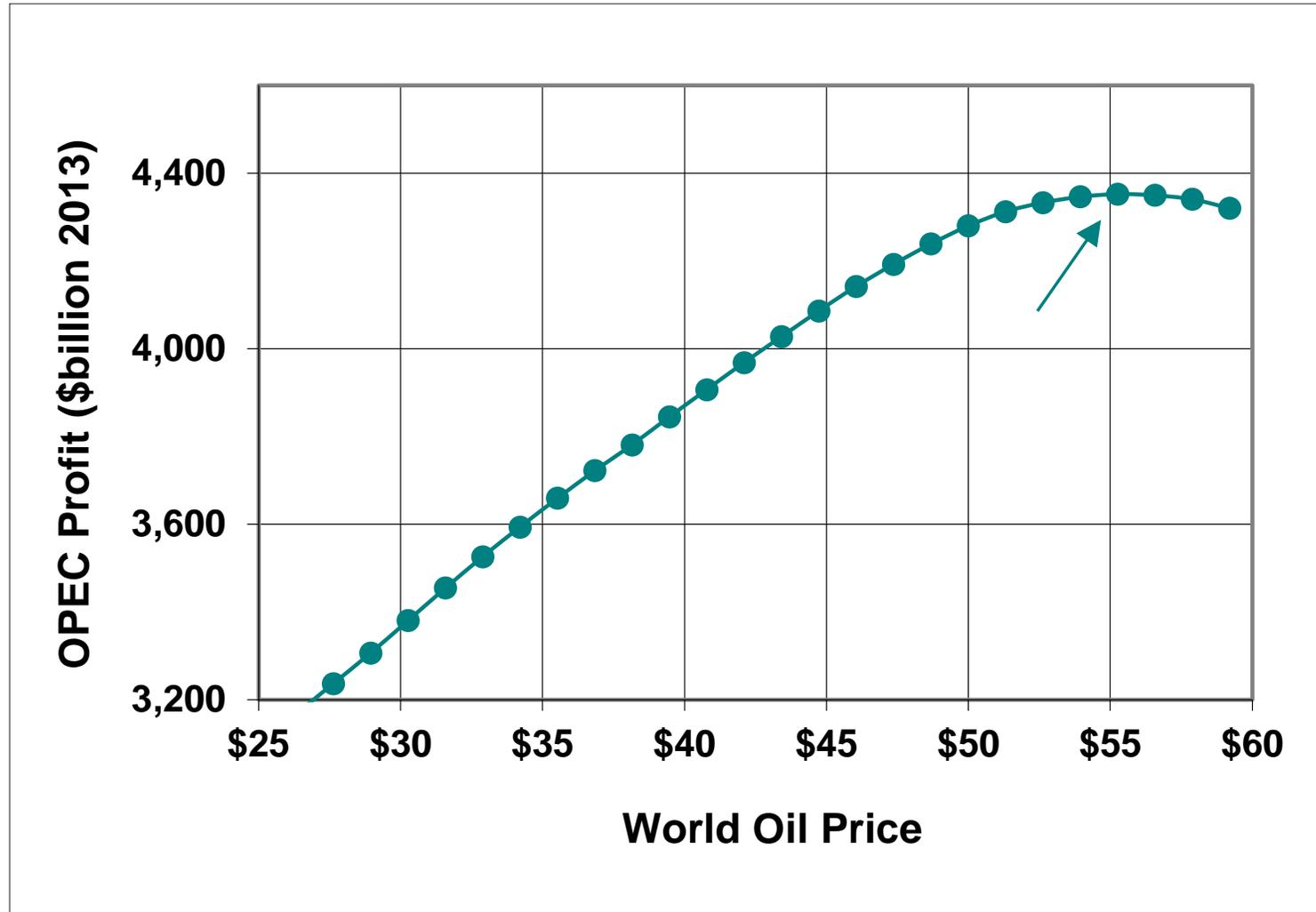
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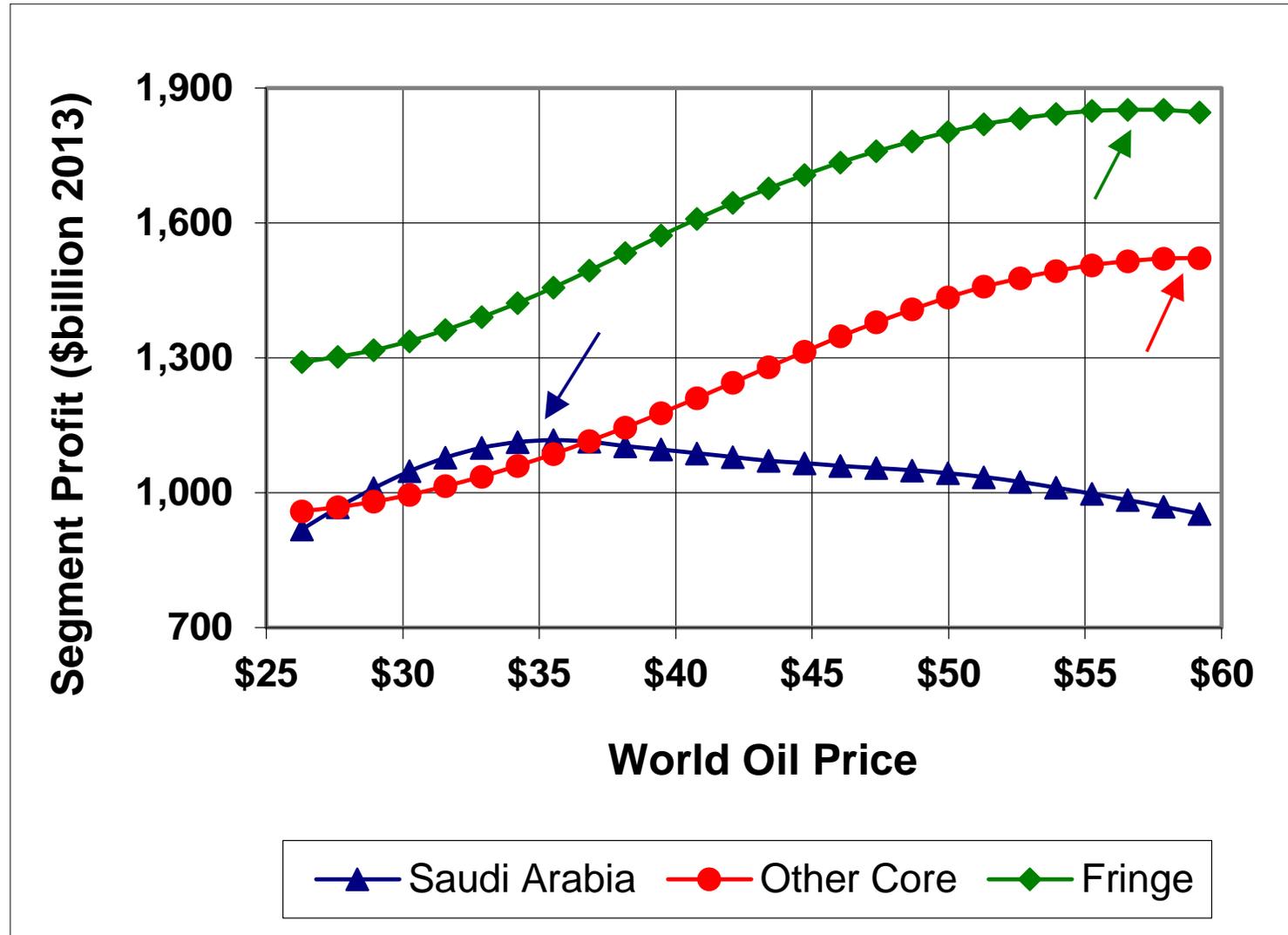
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- To produce more now, OPEC must accept low prices—substantially below \$100/barrel, and expand investment in new capacity.**
- Texas shale oil producers stand up and applaud every time the Saudis urge OPEC production cuts.**
- That alone should be the most obvious signal of OPEC's mistake!**

My View of Long-Term Prices, circa 2005



J. L. Smith, "Oil Prices, OPEC Wealth, and Cartel Cohesion," CEEPR, MIT, April 21, 2005

My View of Discord Within OPEC



My Conclusions Have Hardly Changed Since 2005:

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- **The OPEC price represents a broad compromise among conflicting interests. The economic interests of OPEC members are not aligned.**
- **Prior to October 2014, the Saudis willingly accepted most of the burden of compromise, despite a natural interest in lower prices and risk of stranded assets.**
- **Three years later, have the Saudis already forgotten about the risk of stranded assets? Will they wake up in time?**

Thank You!

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