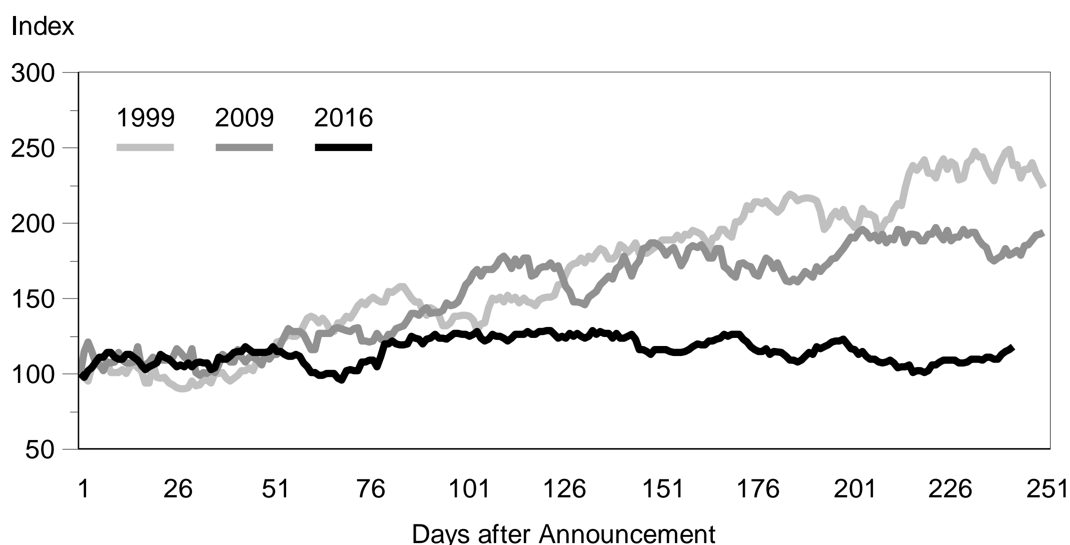
The Petroleum Economics Monthly

Philip K. Verleger, Jr. Volume XXXIV, No. 6 June 2017

Failure to Learn from History: The Production Cut Mistake



Publication Date: 8/4/2017

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Failure to Learn from History:
The Production Cut Mistake

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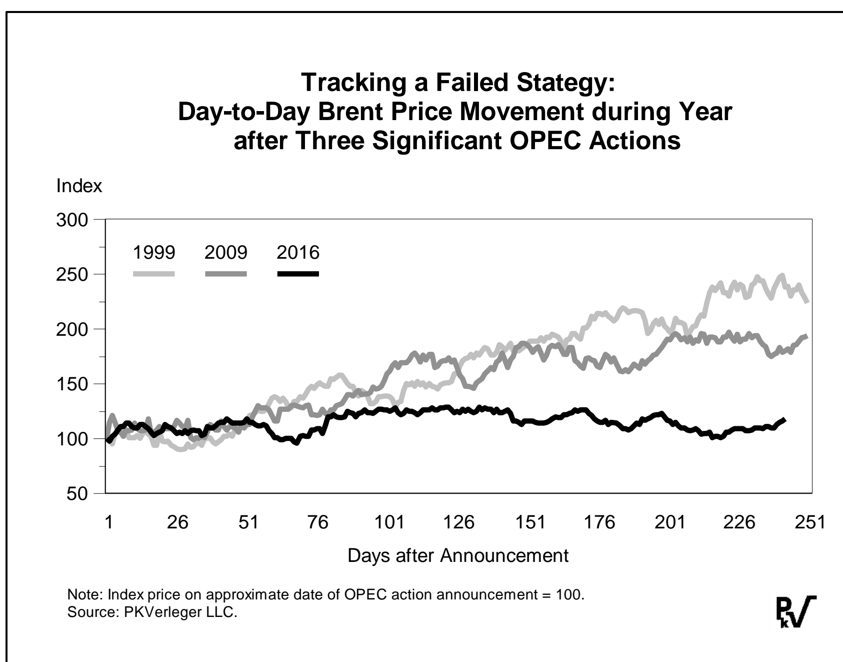
SUMMARY: OPEC'S PUT

The thought that they might create a huge incentive for oil drillers likely never crossed the minds of the oil ministers from OPEC and non-OPEC nations who met first in Algeria last fall, then in Vienna in May, and finally in St. Petersburg in July. They did, however. These ministers literally invited investors to pour billions into funding short-cycle drilling projects undertaken by numerous "non-legacy" oil companies. The consequence has been an unexpected increase in US oil production, a boost that could come close to offsetting the output reductions by the OPEC and non-OPEC producing nations that make up what we've been calling the Vienna Group.

The investor response, along with the reaction of consumers to the prospect of higher fuel prices, has mostly negated the impact of the Vienna Group's production cuts. As a result, oil prices have essentially gone nowhere.

Our cover graph—repeated here—captures the futility of the recent cutback. The figure tracks the daily movement of oil prices over the year that followed three OPEC efforts to raise prices. The first occurred in early 1999 after producers had abandoned all controls on output in 1998. The Saudi oil minister orchestrated a meeting in which the invited OPEC and non-OPEC nations agreed to a joint production reduction. Prices more than doubled in the year that followed. The second episode happened following the 2008 financial crisis. Producers again agreed to cut production. Prices doubled by 2010.



The third agreement was negotiated over the last year and finalized in December. Initially, prices rose. But by spring it became clear that inventories were still high. Worse, oil production in the US, which had been declining more than six percent per year after OPEC's November 2014 meeting, began to rise. The boost was propelled by the cash flowing from investors into drilling firms. The crude oil price recovery stopped.

In announcing their intention to cut output and then doing so, oil ministers, some of whom fancy themselves as the central bankers of oil, had unwittingly copied the strategy of a real central banker: Alan Greenspan. In the 1990s, US investors were fond of describing the "Greenspan put." As academics explain, investors believed at the time that Greenspan would do anything to keep the stock market from collapsing. Greenspan gave them good reason for this belief. As Robert Shiller has explained, Greenspan took proactive actions after the 1987 stock market collapse, after the collapse of Long-Term Capital Management, and in preparation for Y2K.

Investors have responded to the oil ministers' actions just as they responded to those of Greenspan. In 2016 and 2017, money has poured into shale drilling efforts. There was a similar response to the Greenspan put in the 1990s—for example, the exuberant funding of fiber-optic networks. At that time, thousands if not millions of miles of fiber-optic cable were spread across the globe. Firms such as Global Crossing, Williams Communications, and Qwest saw their share prices escalate rapidly as they laid cable. Collapse followed. Today, much of that cable has yet to see the light of data.

The same situation has occurred in oil. Short-term drilling programs are being funded by investors while legacy oil firms go begging.[1] Executives from the latter and oil ministers do not understand this change. Al Walker, CEO of Anadarko, is one. Walker may be an excellent operator. However, he demonstrated complete ignorance of the current role of capital markets when he accused investors at a conference of "rewarding growth" rather than capital efficiency.[2]

His astounding remark reflects a failure to comprehend any of the advanced work on investment theory, especially that of Robert Shiller, whose writings have shown repeatedly that investors aggressively pursue growth opportunities. Walker would likely change his view were he to think about how investors have poured cash into Tesla shares rather than GM or Ford or pursued Amazon shares rather than those of Wal-Mart.

It is this transformation of the global economy that has torpedoed OPEC's efforts to raise crude oil prices. The availability of capital and the willingness to fund firms applying new drilling technologies has blocked OPEC and its collaborators. While the Saudi oil minister has pledged "to do what it takes," the stark economic facts suggest that neither Saudi Arabia nor the Vienna Group has the wherewithal or the cash needed to succeed. The market will prevail if they stick to their current strategy.

Perhaps they will try something else. Former Pimco CEO Mohamed El-Erian, for example, identified three potential approaches in a Bloomberg column titled "OPEC's Game Theory Dilemma." The last of these suggests that OPEC should open the taps:

> The third approach would be for OPEC to go all out to meaningfully disrupt the current production of nontraditional suppliers and, simultaneously, cripple the flow of funds for their investment needs. By allowing oil prices to plummet and stay low for a considerable time, this approach would eat into both operating earnings and investable funds in a manner that would render a recovery tricky and a lot more uncertain for these suppliers. It would be a repeat of what was attempted starting in November 2014, but with more duration and structural underpinnings.

Such a strategy would cause the same losses for investors in fracking firms as happened for those investing in fiber optic. DUCs (drilled but uncompleted wells) would become the new "dark fiber."

This may be the only avenue to recovering market dominance for oil-exporting countries.

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[1] The term "legacy" was first used to describe airlines such as Pan American, Eastern, TWA, National, and Northwest that had operated prior to deregulation. None of these airlines survived afterward. American, United, and Delta did. Meanwhile, non-legacy carriers such as Southwest and Spirit entered the market along with many others.

[2] Walker's full statement appears on page 13.