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OPEC – Gone Are the Days

Cartel (kahr-tel): an international syndicate, combine or trust formed especially to regulate prices and output in some field of business.

Over recent months, I have written five different pieces regarding oil prices. I have covered many fronts as to the price decline in oil - from my recent piece titled "Good Deflation" (published February 2, 2015) to last year's "Iraq Instability and Oil Prices" (published July 7, 2014). Oil prices have rallied over the last five weeks from the low reached last month. On March 17, oil traded at \$43.46 per barrel (WTI). Last Friday, prices rebounded to \$57.74 per barrel, up 32.8 percent from the lows witnessed in March. Still, prices are down 46 percent from June 2014.

During the period where the price was rebounding, oil company stock prices also rebounded. Since March 17, the S&P 500 Energy sector has risen by 9.7 percent in value while the broad-based S&P 500 Index has been up 3.1 percent. Still, oil companies' stock prices are down hard from last summer, as the sector index mentioned is down 18.9 percent and the S&P 500 index is up 7.9 percent.

Nobody knows where oil prices are headed…if someone tells you they do, walk away because they are speculating. When oil prices were tumbling to the downside last fall, market pundits (including myself) were speculating as to why oil prices were falling***. I took the stand that prices were declining due primarily to excessive supply levels as compared to falling demand for oil.*** Most market observers have now come to that same conclusion. The difference between the excess supply/lack of demand explanation is extremely important.

OPEC - The Historical Marginal Supplier of Oil

Prices for any commodity – even a commodity so laced with political impact as oil – are, over the long-term, driven by supply and demand. OPEC has historically (since OPEC took the "supply" reins from the Texas Railroad Commission in the 1970's) been the arbiter of oil supplies on the margin globally. OPEC has been one of the world's more powerful cartels.

For a cartel to function, a number of requirements is needed. As noted in the definition above, OPEC has the power to control oil prices because they historically exercise the following:

1. Cooperation. Output levels (supply) have been regulated by members of OPEC. Cheating on these quotas has occurred in the past, but normally by the smaller producers. ***We suggest the willingness of the large producers to cooperate with***

each other has changed given the new-found regional power which Iran will carve for itself over the next few years.

2. Control over Supplies. With the technological advancements of hydraulic fracturing (fracking), the United States and Canada are now able to produce more oil than Saudi Arabia, who was long believed to possess more oil reserves than anyone else. With this profile, along with Iran, Iraq, United Arab Emirates (UAE) and Venezuela, the marginal suppliers of oil have been OPEC member countries. This critical factor has changed over the last few years. ***We suggest this change is here to stay. Additionally, we suggest oil "lifting" prices will continue to decline over time as technological change begets more technological change, driving drilling and fracking costs lower.***

With these two factors in mind, what was unthinkable a year ago is now thinkable: ***OPEC may lose its ability to control oil prices over the long term.***

Stepping Trhough the Details

Historically, OPEC has acted as a basic driver behind global economic and socio/political forces, be them positive or negative for the last 40+ years. ***Our analysis suggests a major arbiter of economic factors has changed***. Making this kind of statement will seem radical to some, and indeed I have struggled with this issue over the last number of months.

Two firms have recently written about the prospect that OPEC has lost its ability to directly control oil prices through supply manipulation. Trend Macrolytics, headed by Donald L. Luskin, initially brought this prospect to my attention a few months ago. Now, Robert Ryan and Marko Papic from BCA Research have come to the same conclusion: ***OPEC will eventually lose its ability to directly control oil prices in the future***. There will be a period of time where this major change won't be apparent. But, given where the world currently stands economically and politically, ***the prospect of this change occurring is rather high.***

Some driving details behind this major thought:

Geopolitical Order Change

Turmoil in the Mideast has long been a driver behind volatility in oil prices. ***Per our friends at BCA, "a cartel cannot be maintained when its members are openly at war with each other." Considering the current and potential future positions of Iran, Saudi Arabia and the United States, one can conclude that the probability of military conflict between the Sunni and Shiite factions in the Mideast is a reasonable expectation.*** The U.S., long the arbiter of political and military power in the Mideast has ***abandoned this role***. This action has created a power vacuum. Vacuums don't stay unfilled for long. It now ***appears Iran as accelerating as a prospective power broker in the Mideast.***

Most know Iran is predominately a Shiite Muslim country. Saudi Arabia is dominated by Sunni Muslims. It looks like an "intra-holy" war may be launched between the Shiite's and Sunni's – as Iran appears to be keen on taking over (at least in influence) Iraq. So, the geopolitical map in the Mideast could be redrawn. As stated above, "a cartel cannot be maintained when its members are openly at war with each other." ***We believe at the end of the day, Iran will become the arbiter of political and economic power in the Mideast.***

Speculation abounds that the Saudi's will create a working relationship with another Sunni Muslim country – perhaps Egypt. If this occurs, ***the die will be cast for continued conflict in the Mideast, driven not between western and local power bases, but between Sunnis and Shiite Muslims.*** Don't get me wrong, the U.S. won't fully exit the Mideast area. But by positioning Iran as a "pivot player", like China was in the 1970's, the U.S. can free up diplomatic focus and military resources for other purposes. Iran is the obvious winner here – with the U.S. off its back***, Iran can focus on building its economy and dominating the Mideast within foreign policy circles.***

As Iran gains diplomatic, economic and military muscle in the Mideast, the ***Saudi's could be the clear looser within the OPEC countries. With the U.S. de-focusing on the Mideast, the Saudi's (and the Israeli's) wonder if they need to forge forward on their own.*** It is highly possible that one factor which led to the Saudi's decision not to cut oil output last year was driven by an attempt to impair Iran's influence in the region.

Going forward, why would the Saudi's support an organization (OPEC) which helps its rival (Iran)? The Saudi's are weaker than Iran by many geopolitical power measures. While the Saudi's have huge capital reserves (latest count at $734 billion as of 2014), their military base is small. If the U.S. will not launch "boots on the ground" in the Mideast, I assume they will retain a certain degree of naval power in the region***. "Boots on the ground" – to the degree this is necessary – will have to be manned by the Saudi's and the Egyptians vs. the Iranians and the Iraqis and the UAE***. While this possibility is some ways off – and may never happen – the other alternatives facing the Saudi's seem unworkable. ***Again, the key is the U.S.'s diplomatic "pivot" which has happened as the U.S. has opened the door for Iran to gain military, economic and political power within the Mideast.***

What This Means for OPEC

First, we need to understand that the move by the United States to ***pivot away from the Mideast has been made possible by technological change within the world's oilfields.*** Fracking and the technology behind this action opened up oil production in areas heretofore not possible. It is foreseeable that the United States will not need to import massive amounts of oil from foreign sources***. As compared to average oil imports from 1973 – 2014, U.S. imports are down 34 percent from Saudi Arabia, down 75 percent from Algeria and down 82 percent from Libya. The United States is becoming oil independent***, due specifically to technological innovation. As we have seen in other fields, technological innovation begets further innovation which should continue to drive oil "lifting" costs lower.

As stated above, the Mideast has been facing a power vacuum as the United States withdraws political/military/economic support to the region. This vacuum is being filled by locals, as the Sunni and Shiite segments of the Muslim religion are facing off in the region. If battle lines continue to be drawn in this push for power, ***it appears Iran will be the new power broker in the region***. The Saudi's have always had a power base in the region because ***the United States has consistently supported the Saudi-centered structure. This dynamic has apparently changed.***

The risks of OPEC's survival are real. Will OPEC survive this new power struggle? Perhaps, but in the meantime expect oil prices to experience high levels of price volatility. Could the Iranians and the Saudis come to some type of agreement on production and bolster the feasibility of OPEC staying together? Yes. This occurred during hostilities in the 1980s. The

difference now, however, is that the United States is pivoting away from the Mideast. The United States will never fully leave the Mideast, but our country's desire to help drive overall economic/political policies within the region have obviously waned.

At times, political wars turn into military wars. We can't rule this possibility out in the Mideast. Additionally, if the Iran/Saudi conflict builds, oil prices will probably spike upwards…at least temporarily. We haven't addressed the building of Iran's nuclear capabilities. That is another wild card which needs consideration.

Investment Implications

As Iran gains power within the Mideast, expect to see Shiite-based oil production to move upwards to the 10-13 million barrel per day range over the next five years. At this production level, Sunni-based (Saudi) production domination would be challenged. Under this scenario, oil prices - over a period of time- would not rise dramatically.

We need to keep in mind that power struggles are never linear in nature. Fits and starts occur. In this environment, oil prices would be volatile, at least temporarily. The geopolitical risks that would accompany the end of OPEC as the marginal determinant of oil pricing are huge. Think of a badger. If a person happens to stumble onto a badger, the badger may want to avoid any type of confrontation. On the other hand, if a person corners a badger, there is little doubt the badger would come out fighting, giving the discoverer a very unpleasant experience.

We believe the ***probability of OPEC members being forced into a corner in the coming years is somewhat high. We expect political and military conflict to arise from the demise of OPEC as we have known it. Eventually one needs to weigh the trustworthiness of Iran since they will apparently possess nuclear capabilities in the future.***

The Arabian Peninsula is the original home of the Bedouin people. According to Muslim tradition, these are people whom Muhammad succeeded in converting to Islam prior to his death. An old Bedouin proverb - courtesy of BCA is:

> *I against my brother,*
> *I and my bother against our cousin,*
> *I, my brother, and our cousin against the neighbors,*
> *All of us against the foreigner.*

We will be back next week.

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