

What is Behind the Steep Decline in Crude Oil Prices: Glut or Geopolitics?

By Mamdouh G Salameh*

Introduction

The crude oil price has lost 54% of its value since September 2014 and there are no indications that it will stop there in the absence of a major production cut by OPEC. It is not inconceivable that the price could even slide to \$40 a barrel.

The reasons given so far for the steep oil price decline is glut in the global oil market caused by rising U.S. shale oil production and a slowdown in economic growth in China and the European Union (EU) reducing the demand for oil. This was exacerbated by OPEC's very wrong decision not to cut production by at least 2 million barrels a day (mbd) to absorb the glut in the oil market. Had they cut their production, Russia and Mexico would have joined them and cut production by 500,000 barrels a day (b/d) and 300,000 b/d, respectively, a total of 2.8 mbd capable of removing the glut and stabilizing the oil price. It is not too late for OPEC to reverse their earlier decision and cut production.

Still a glut in the global oil market estimated at 1-2 mbd and slightly slower economic growth in China and the EU should not have led to such a steep decline in oil prices. The global economy suffered harsher and more dire banking and economic crises during the period of 2009-2011 and still oil prices never declined as steeply and for such a long time.

Circumstantial evidence suggests some political collusion between Saudi Arabia and the United States behind the steep decline in the oil price.

Saudi Arabia took advantage of the low oil prices to inflict damage on Iran's economy and weaken Iran's influence in the Middle East in its proxy war with Iran over its nuclear programme whilst the United States is taking advantage of the low oil prices to weaken Russia's economy and tighten the sanctions against Russia over the Ukraine.

Saudi-U.S. Collusion

History is repeating itself. Early in the 1980s, Sheikh Ahmad Zaki Yamani, the veteran, former oil minister of Saudi Arabia, suddenly awoke to Saudi Arabia's need for market share. He flooded the market with oil causing the oil price to collapse to \$10/barrel. It later transpired that the Saudi need for a market share was just a cover for a CIA-Saudi conspiracy to hasten the demise of the former Soviet Union.¹

And now the Saudi oil minister Ali Al-Naimi is waking up to the same need. Al-Naimi has followed in the exact footsteps of Yamani. He suddenly remembered at the 166th Meeting of the Conference of OPEC on the 27th of November 2014 the need for Saudi market share. This is probably a cover for a new collusion between the United States and Saudi Arabia to lower the oil prices in a new conspiracy against Russia and Iran. Whilst the key players have changed, the strategic objectives have remained the same.²

Impact of Low Oil Prices on the Global Economy

The global economy can't reconcile itself with low oil prices for a long while because the main ingredients that make up the global economy such as global investments, the oil industry and the economies of the oil-producing countries, will be undermined.

A continuation of low oil prices could damage the global economy in many ways. Whilst oil consumers around the world may enjoy for a short while low crude oil prices, eventually global consumption will overtake global production and that will push oil prices steeply up. Already crude oil's plunge has fuelled a big jump in U.S. petrol demand.³ Current low oil prices could be planting the seeds for a future damaging oil crisis in the next two to three years.

The challenges facing the global economy in 2015 are manifold. One important challenge is a curtailment of global investments in many sectors of the global economy particularly the oil and energy sector.

Another is a sustained damage to the global oil industry. The seven major oil companies - Royal Dutch Shell, BP, Exxon Mobil, Chevron, Total, ENI and Statoil - need a price of \$125-\$135/barrel to balance their books.

In January 2015, Schlumberger, Halliburton and Baker Hughes, the three largest international service companies in the world reported that spending by their customers is dropping by 25-30% in North America compared with 10-15% in

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See footnotes at end of text.

the rest of the world. They also reported a 29% drop in the number of rigs drilling for shale oil in the U.S. from October 2014 to January 2015.

While the world-wide slide in the price of oil has focused attention on the United States' relatively new shale oil fields, it is the mature, high-cost fields such as those in the North Sea that seem likely to suffer most. At prices much below \$75 a barrel, some of the North Sea reserves might be too expensive to develop.⁴

In 2003, the seven majors produced 11.5 mbd of oil liquids, or 14.5% of global output of 79.6 mbd. Fast forward 10 years and their smaller output of 9.5 mbd is equivalent to only 10.4% of larger global production of 91.6 mbd. Oil majors have very little leverage over actual oil prices today.

The faster downturn in the North American industry is in part explained by the higher costs of U.S. and Canadian production compared with oil from the Middle East. A break-even price for U.S. shale oil production was estimated at \$70-\$85 per barrel. While some efficient shale oil drillers could live with an oil price of \$50-60 a barrel, many of them are fracking themselves to bankruptcy.

Impact on the Arab Gulf Oil Producers

My calculations show that the Arab Gulf oil producers earned an estimated \$452 bn in 2014, down 21% on 2013 earnings. They are projected to earn \$340 bn in 2015 based on an average oil price of \$60/barrel throughout 2015 (see Table 1).

Country	(US\$ bn)		
	2013	2014	2015
Iran	86	74	55
Kuwait	92	34	25
Saudi Arabia	274	208	156
UAE	53	42	31
Oman	27	22	19
Total	574	452*	340*

Source: U.S. Energy Information Administration's (EIA) 2014 Short-term Energy Outlook (STEO) / Author's projections for earnings in 2014 & 2015.

*Based on an average price of oil of \$60/barrel in the second half of 2014 & 2015.

Table 1. Net Oil Export Revenues of the Arab Gulf Oil Producers

If oil prices continue at \$50/barrel for a year, Saudi Arabia alone will lose an estimated \$128 bn.

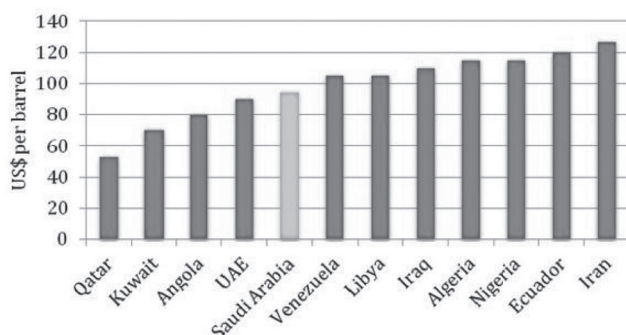
Saudi Arabia is forecast to reduce state expenditure to \$229 bn this year, down 18% on 2014, a clear sign of the impact the slump in crude prices is having on its finances. It will end up with a \$38 bn deficit amounting to 6% of Saudi GDP. As a result, Saudi Arabia's non-oil economy would contract by 5% this year.⁵

Weakened oil prices have resulted in the rating agency Standard & Poor (S&P) downgrading its outlook for Saudi Arabia. "We view Saudi Arabia's economy as undiversified and vulnerable to a sharp and sustained decline in oil price," S&P said. Saudi Arabia's petroleum sector accounts for 44% of its GDP.

And now Saudi Aramco, the largest oil producer in the world, has been advised by the Saudi government to slash its future spending on production and exploration by as much as 25% from \$40 bn to \$30 bn.⁶

However, Aramco isn't the only big state-owned oil company seeking to cut costs. Suhail bin Mohammed al-Mazroui, the UAE oil minister, said in January that his country, along with other producers, would squeeze oil contractors' costs to adapt to lower oil prices. "We will need the service companies and contractors to understand the cycle of the oil market," he said at an energy event in Dubai.

Some OPEC countries need very high prices to "break even" in their budgets and pay for all the government spending they have racked up in recent years. Iran for instance, needs prices at around \$130 a barrel while Saudi Arabia needs an oil price of US\$106/barrel in 2015 to fiscally break even, up from \$98 a barrel in 2014 according to the International Monetary Fund (IMF) (see Figure 1).



Source: OPEC "Break-even" Prices (Matthew Hulbert/European Energy Review).

Figure 1. OPEC Median Budgetary Breakeven Price

The Arab Gulf oil producers will always be vulnerable to declines in the oil price as long as they continue to be dependent on oil export revenues to the tune of 85%-90%.⁷ This is because they have not diversified their economies since the discovery of oil in their territories in the early twentieth century.

In addition to their vulnerability to the volatility of the oil price, the greatest threat to their oil-dependent economies comes from the steeply-rising domestic oil consumption for power generation and water desalination and a lack of diversification. A precursor of this consumption is the wasteful subsidies.

This means that the GCC countries will have to cut their domestic oil consumption drastically or replace oil by nuclear power and solar energy in electricity generation and water

desalination. Failing to do either would result in their relegation to minor crude oil exporters by 2030 or ceasing to remain oil exporters altogether by 2032 (see Table 2).

Impact on Iran's Economy

The international sanctions against Iran and the steep decline in the oil price have adversely affected the value of its currency and reduced its oil exports from 1.81 mbd in 2012 to 1 mbd in 2014 (See Table 3).

However, before the recent fall in the oil price, Iran was selling its crude at an average price of \$105-\$110/barrel. At \$60/barrel, the government will face a shortfall of about \$14-\$16 bn compared to original plan, or 27%-31%, of total planned government revenue.

Iranian President Hassan Rouhani was quoted by Reuters on January 13, 2015 as saying that countries behind the fall in the global oil prices would regret their decision and warned that Saudi Arabia and Kuwait would suffer alongside Iran from the price drop. He added that "If Iran suffers from the drop in oil prices, other oil-producing countries such as Saudi Arabia and Kuwait will suffer more than Iran. In 2013 oil accounted for roughly 90% of Saudi Arabia's overall budget income and 92% of Kuwait's according to Reuter's calculations based on official data. On the other hand, only a third of Iran's budget is based on oil sales, with an estimated 60% of the country's exports tied to oil".

Impact of Sanctions & Declining Oil Prices on Russia

Sanctions were imposed on Russia in the aftermath of its intrusion into the Ukraine in February 2014 and the ensuing annexation of the Crimea.

In 2013 more than 45% of the national budget was funded by gas and oil revenues estimated at \$219 bn.⁸

The combination of sanctions and falling oil price has adversely affected the Russian economy by sending it to recession and causing the Russian currency to lose 40% of its value against the dollar.

Russian international reserves also decreased from \$510 bn to \$386 bn during 2014. Moreover, the combined effect of sanctions and low oil prices has resulted in downside pressure on Russia's GDP. GDP growth slowed down to only 0.7% in the third quarter of 2014 (see Figure 2). Based on an average oil price of \$78/barrel in 2015, the World Bank forecasts real GDP contraction by 1.7% for Russia.⁹

While the international sanctions against Russia have had so far little effect on the Russian economy, it is the declining oil prices that have had the biggest impact. Still, Russia will be able to withstand the onslaught of sanctions, declining oil prices and currency depreciation by increasing its oil exports and by having a trump card in China's energy needs and financial support.

Impact on the U.S. Shale Oil Production

The surge in U.S. shale oil production over the past five years has been truly phenomenal, but the notion that it was ushering in a new age of global oil abundance is looking more exaggerated by the day.

Year	Production	(mbd) Consumption	Net Exports / Imports
2010	16.65	4.59	12.06
2011	18.70	4.77	13.93
2012	18.92	5.35	13.57
2013	19.07	5.99	13.08
2015	19.51	6.38	13.13
2020	20.90	9.64	11.26
2025	19.83	13.19	6.64
2030	18.55	17.06	1.49
2031	18.44	17.91	0.53
2032	18.33	18.81	- 0.48
2035	17.79	21.78	- 3.99

Sources: US Energy Information Administration (EIA), Oil Outlook 2013 / OPEC Annual Statistical Bulletin 2014 / BP Statistical Review of World Energy, June 2014 / Author's projections.

Table 2. Combined Current & Projected Production, Consumption & Export of Crude Oil Exports in the Arabian Gulf Countries, 2010-2035

	(mbd)									
	2009	2010	2011	2012	2013	2014	2015	2020	2030	
Production	3.56	3.54	3.58	3.74	3.56	3.15	3.17	3.40	3.35	
Consumption	2.01	1.87	1.91	1.93	2.00	2.15	2.17	2.57	3.63	
Net exports/Imports	1.55	1.67	1.67	1.81	1.56	1.00	1.00	0.83	-0.28	

Sources: IEA's World Energy Outlook 2014 / BP Statistical Review of World Energy, June 2014/ OPEC Annual Statistical Bulletin 2014 / Author's Estimates.

Table 3. Iran's Current & Projected Crude Oil Production, Consumption, Exports & Sustainable Capacity, (2009-2030)



Source: www.tradingeconomics.com, Federal State Statistics Service

Figure 2. Russia GDP Annual Growth Rate (percent change in Gross Domestic Product)

One need only look at the trend in the number of rigs drilling for oil in the U.S. to see that the shale oil industry is now in severe crisis. The U.S. rig count is now down by 469 units (29%) since October, and is at its lowest level since December 2011.¹⁰

The implications of shale oil's treadmill dynamics have until now been largely overlooked by the market. The declining oil prices have prompted the sharp drop in the U.S. rig count. However, once the impact of a dramatically lower rig count starts feeding through into shale oil supply from the middle of the year, prices should start to rally on a more sustained basis, with Brent likely to be back at \$75 a barrel by year-end. The shale model simply does not work without high prices, and the market is starting to understand that.

In a way, oil companies in the U.S. are perpetuating the crash by continuing to drill and push up U.S. shale oil production to its fastest pace ever. Rather than pulling back in hopes of slowing the amount of supply on the market to try and boost prices, drillers are instead operating at full tilt and pumping oil as fast as they can. So will U.S. shale oil producers frack their way into bankruptcy? That's a real possibility now.

However, the biggest obstacles to an expansion of US shale oil production would be a backlash against its adverse impact on the environment and rising costs of production resulting from the steep first year decline rate of 70%-90% for new wells. Without higher prices exceeding \$90/barrel, no one would be chasing shale oil.

Can OPEC Disrupt U.S. Shale Oil Production Surge?

OPEC's ability to push prices lower to disrupt new emerging sources of supply is constrained by members' higher fiscal break-evens, a result of the social turmoil unleashed by the Arab Spring.

OPEC members need prices at least as high if not even higher to the ones that shale drillers need to sustain their businesses. Saudi Arabia needs oil prices above \$100/barrel to sustain the extra spending. Other Arab Gulf producers are in a similar situation. On the other hand, U.S. shale developments need prices of \$70-\$85/barrel to break even, according to industry estimates. The shale boom, thus, is not in danger of an OPEC attack.

Conclusions

A continuation of low oil prices could damage the global economy, inflict sustained damage on the global oil industry and the economies of the oil-producing countries in the world.

Moreover, declining oil prices could be planting the seeds for a future severe oil crisis in two to three years.

The global economy can't reconcile itself with low oil prices for a long while. That is why I am convinced that oil prices will start to rebound soon. My projection is that the oil prices will start to recover by the second half of 2015 probably reaching \$75/barrel and recouping most of their earlier losses.

Footnotes

¹ Seyed GholamHosein Hassantash, "Naimi in Yamani's Attire; Are Authorities in Riyadh Witless or Lying? History is Being Repeated", IAEE Energy Forum, 1st Quarter of 2015, p.21.

² Ibid.,.

³ Ed Crooks & Gregory Mayer, "Crude's Plunge Fuels Jump in U.S. Petrol Demand", Financial Times, 16 January, 2015, p. 28.

⁴ Selina Williams & Justin Scheck, "North Sea Region Is Hot as Oil's Tumble Persists", Wall Street Journal, January 16-18, 2015, p.1.

⁵ Financial Times, 16 January, 2015, p. 5.

⁶ Summer Said & Benoit Faucon, "Oil-Drop Pain Spreads to Saudi Arabia's Behemoth", Wall Street, February 19, 2015.

⁷ Mamdouh G Salameh, "Impact of U.S. Shale Oil Revolution on the Global Oil Market, the Price of Oil & Peak Oil" (a paper given at a Symposium of Peak Oil, 2-4 April, 2013, Doha, Qatar).

⁸ Mamdouh G Salameh, "Turning the Gaze towards Asia: Russia's Grand Strategy to Neutralize Western Sanctions" (A USAEE Working Paper No: 14-168, posted on 19 July, 2014).

⁹ Elvin Mirzayev, "Sanctions & Oil Prices Bring the Russian Economy Near Collapse" 21 January 2015, accessed on 2 February 2015 at www.investopedia.com.

¹⁰ Selina Williams & Justin Scheck, "North Sea Region Is Hot as Oil's Tumble Persists", p.1.