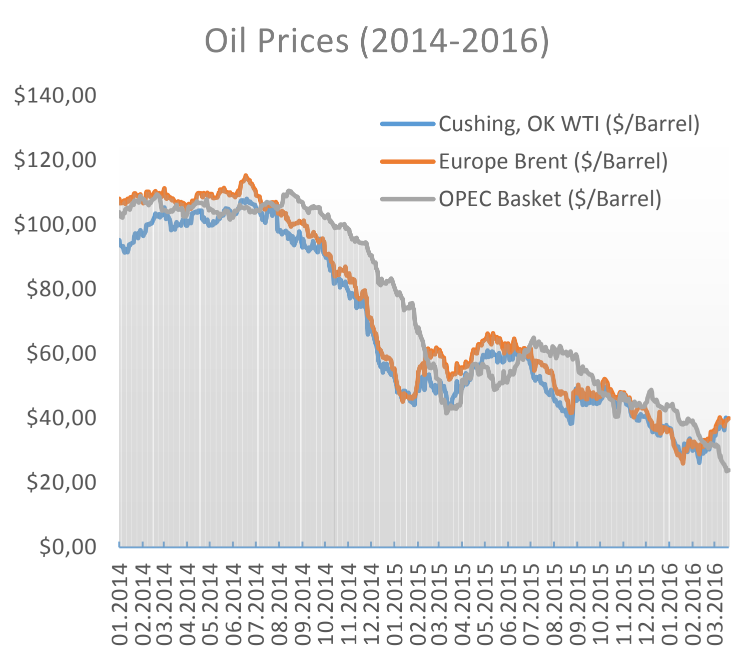
EUCERS/KAS/ISD Energy Talks 2016

Oil Prices – How low? How long?

By José A. Bolanos, KAS Energy Security Fellow @ EUCERS.

Oil prices have fluctuated by over $100/barrel in the span of a decade: $50/barrel in January 2007, $147 in July 2008, $30 in December 2008, $123 in March 2013, $40 in August 2015. The last downturn was triggered in 2014 by OPEC's end-of-the-year decision to not cut production, but this decision can be traced further back. OPEC's decision was itself a result of the fact that high oil prices were enabling competition from a number of non-OPEC players. US shale oil is the most visible example, but not the only one. Two prominent examples include: the increasing viability of Canadian oil sands prior to 2014, and the keen interest in exploring the viability of Arctic oil. Regardless of which was the first or main cause, the sheer availability of oil in the market caused prices to drop rapidly from 2014 to 2015. In January 2014 the price of oil was of $95.14 (WTI), $107.94 (Europe Brent), or $103.82 (OPEC Basket) per barrel and although prices fell slightly over the year, prices held over $90 per barrel until October 2014. By November 27th, date of the now infamous OPEC meeting, WTI and Brent prices were at $73.7 and $77.39 per barrel, respectively but would soon drop to trade under $50 per barrel throughout January 2015. As such, and as shown in the figure above, since late 2014 prices have remained low.



Source: Energy Information Agency (EIA) & Organization of the Petroleum Exporting Countries (OPEC).

We should be aware that this is not the first time that the industry has faced these type of low-price challenges. The beginning of the modern oil industry was marked by a bust derived from an excess of supply. In 1859, after Colonel William Drake successfully drilled the first modern oil well, oil sold as high as $20 per barrel.[1] This soon led to an investment frenzy that overloaded the market and caused prices to drop to about ten cents per barrel.[2] Far of disintegrating the oil industry, and despite the fact that many business initiatives did go under, the collapse in prices fostered the uptake of oil within society. This was the first period of struggle, but it would not be the last. Even Rockefeller himself was, at one point, concerned about his ability to remain in business long enough for prices to come back up.[3] He responded by suffocating competitors until they exited the market. Many believe that Saudis are now fostering the same type of situation by ensuring that prices stay below the viability line of most other producers. As such, some analysts believe that Saudi Arabia will not let oil prices rise significantly.[4]

There are however a number of aspects that may force prices up in the short term. First, the strategy may have already borne fruit. As reported by Rystad Energy, production in US companies with a focus on shale decreased slightly in 2015 and, more importantly, investment fell substantially.[5] Statistics from Baker Hughes show that the count of rigs around the world fell by more than 1,000 over 2015. Even BP and Shell recently announced staggering losses. Saudi Arabia may be successfully implementing the oldest strategy in the oil man's book, flooding the market to force competitors out. Some analysts now believe that the glut will be over as soon as in 2016 due to the severe underinvestment in new projects in the past few years.[6] Second, many producing countries may not have the capacity to sustain the low price strategy for much longer. Saudi Arabia for example, arguably the strongest oil producing country, ran a $100 billion deficit in 2015. This led it to announce measures to modernize the economy that include the country's very fist tax rate (5% VAT).[7] Earlier in the

[1] *Cf.* Sherman, J. (2002) *Drake Well Museum and Park: Pennsylvania Trail of History Guide.* Mechanicsburg, PA: Stackpole Books, p. 13; Tarbell, I. (2009) *The history of the Standard Oil Company* [Vol. 1]. New York, NY: Cosimo, p. 10; Robinson, P (2006) Petroleum processing overview. *In* C. S. Hsu & P. Robinson (eds.), *Practical advances in petroleum processing* [Vol. 1]. New York, NY: Springer, p. 3.

[2] *Cf.* Tarbell, I. (2009) *The history of the Standard Oil Company* (Vol. 1). New York, NY: Cosimo, p. 12; Yergin, D. (2009) *The prize: The epic quest for oil, money & power* [3rd ed]. New York, NY: Free Press, p. 14.

[3] Yergin, D. (2009) *The prize: The epic quest for oil, money & power* [3rd ed]. New York, NY: Free Press, p. 24.

[4] See for example Mourdoukoutas, P. (2016) *Saudi Arabia Won't Let Oil Prices Stay Over $40* [Online]. New York, NY: Forbes. Available from: http://goo.gl/B7gxHV [28/03/2016].

[5] Nysveen, P. & Wei, L. (2016) *Shale's response to low oil price environment- summary of 2015 and outlook of 2016* [Online]. Oslo, Norway: Rystad Energy. Available from: http://goo.gl/1BN4fS [28/03/2016].

[6] See for example Stafford, J. (2016) *Why we could see an oil price shock in 2016* [Online]. Tysons Corner, VA: USA Today. Available from: http://goo.gl/iGuUQo [28/03/2015].

[7] Cunningham, N. (2016) *Low Oil Prices Forcing Saudi Arabia To Modernize Economy* [Online]. London, UK: OilPrice.com. Available from: http://goo.gl/0sl5iQ [28/03/2015].

year, Saudi Arabia and Russia showed interest in at least freezing production. Whilst greatly symbolic, the event was interpreted by many as a sign that the countries are finding it increasingly hard to cope with low oil prices. There may be no single player in the market with the capacity to survive a 'war of attrition'. Third, currently only a few producers (amongst them Saudi Arabia, Iran, Iraq, Kuwait, the United Arab Emirates and Russia) are producing at a cost lower than the price of oil. However, Western oil companies have been improving efficiency substantially over the last few years. These improvements may enable profitability at lower prices. This would eliminate OPEC's ability to force competitors out of the market and thereby make it rational for all producers to lower supply.

As noted, analysts are divided over whether oil will bounce back. It may indeed. Low prices may kill producers elsewhere and thereby limit supply. Actors may voluntarily reduce output, given pressure in other aspects of their political economies. That said, there are also no signs for strong economic development that could fuel demand for oil. As such, it is doubtful whether oil prices can recover significantly or even sustainably. The future may be one of violent seasonal price volatility. Even if oil prices do bounce back the question of 'how much' and 'how long' remains open. Join us for the second 2016 EUCERS/ISD/KAS Energy Talk to discuss more about this challenging topic!