Saudi Oil-Market Strategy Shakes Moscow, Tehran and Caracas

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OPEC held its 166th conference in late-November 2014, to decide on a strategy addressing oil prices that had been falling at 5-to-10% per month since July [Figures 1 & 2]. Rather than the usual production cut to boost prices, OPEC adopted a Saudi proposal to maintain output steady at 30 mb/d (million barrels/day).[1] The explicit intent of the Saudi strategy is to drive prices down until the highest-cost non-OPEC producers are forced from the market, with their shares reverting to the "most efficient producers"—that is, to OPEC. However, for Russia, Iran and Venezuela this Saudi strategy is ruinous, so much so that many in these countries declare the whole affair a geopolitical plot hatched by the Saudis in league with the US and EU.

While the impacts on Russia and Iran are certainly not unwelcomed by Riyadh (or, for that matter Washington or Brussels), Saudi oil minister Ali Al-Naimi insists that today's new market realities—in his estimation some 4 million barrels of marginal production—had presented OPEC with no choice but to defend its market share in this manner.[2] And, he makes no secret that the high-cost producers the Saudis want to force from the market are epitomized by the new, high-tech, hydraulic fracturing producers of shale oil in the USA. In this scenario, pain imposed on Moscow, Tehran and Caracas is but collateral damage to states already facing crises rooted in their politics.[3]

Oil's New Political-Economic Landscape

The past decade of high oil prices, only temporarily interrupted by the Great Recession of 2008-09 [Figure 2], enabled a plethora of small- and medium-sized US "fracking" firms and other marginal producers to take significant market share. As long as prices remained high, this was not an existential difficulty for OPEC. However, when prices began to fall in mid-summer 2014, the impact was especially felt by OPEC's "price-hawk" faction. These are high-population OPEC states earning export-revenues-per-capita several times less than the Saudis and small Gulf OPEC states.[4] In the run up to the OPEC conference, it was especially Venezuela, Iran, Algeria, Nigeria and other poorer, higher-population states that militated for OPEC to cut production to prop up prices. However, Al-Naimi insisted that oversupply was so great that any cut would only be effective if non-OPEC producers joined in. The Venezuelan foreign minister, Rafael Ramirez, took the lead trying to satisfy al-Naimi's condition. Following a round of shuttle diplomacy, Ramirez brought the Mexican and Russian oil ministers to meet Al-Naimi in Vienna before the OPEC conclave began there. Already, Al-Naimi had made Ramirez' job tougher by publically acceding to pleas by Iran, Iraq and Libya to be excused from any OPEC production cuts, as their outputs were already depressed due to sanctions or conflicts. In the ensuing sessions Ramirez himself

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[1] "OPEC 166th Meeting concludes," No 7/2014; Vienna, Austria; 27 Nov 2014 http://www.opec.org/opec_web/en/press_room/2938.htm

[2] Ibid., MEES.

[3] MEES: "**Although you say that low oil prices are not a political conspiracy, the coincidence is that Russia and Iran are the two countries suffering most as a result of low prices.** " Al-NAIMI: "Yes, but that is the result of their political actions. Iran and Russia are both under sanctions. It is true that they have been affected by the oil price, and they were in better shape when the price was $100/B. But that is not the problem. Their problem is more basic than that." Ibid, MEES.

[4] T. W O'Donnell, "Cracks in OPEC – Political-Economic basis for two factions with two different geopolitical roles," 12 June 2011. http://globalbarrel.com/2011/06/12/cracks-in-opec-political-economic-basis-for-two-factions/

reportedly offered to cut Venezuela's production by a mere 5% given the dire economic straits late-president Hugo Chavez had left the country in. In a later interview, Al-Naimi related what the Russian oil minister then offered:

"… He [i.e., Ramirez] asked the Russian minister, who was also accompanied by the head of Rosneft Igor Sechin. He provided information about the Russian oil industry. In the end, he said he could not make any reductions because their wells are old, and if they reduce, the wells will not come back up. The minister confirmed that Russia was not willing to cut. We said "thank you" and the meeting was over."[5] So too, the Mexican minister explained his country's difficulties.

With both OPEC and non-OPEC producers unable to cut, the OPEC conference agreed there was no choice but to maintain production until falling prices force sufficient high-cost producers from the market. After the vote, Ramirez hurriedly left, avoiding the press and Venezuela's president quickly announced his demotion to UN ambassador.

"Perfect Storm" driving prices down

From mid-2014, a veritable "perfect storm" of market factors towards lower prices was gathering such that, had OPEC alone cut production and pushed prices up, it would have just given market share to USA shale-oil producers who would simply continue expanding.

In the mid-1980's, during the Iran-Iraq War, a similar oil glut had occurred (worsened by Britain allegedly dumping North Sea oil). Initial Saudi attempts to prop up prices via production cuts caused a disastrous loss of OPEC market share. Then, as now, the Saudis gave up defense of price in favor of market share. They flooded the market with oil during 1985-86, provoking the "Saudi net-back crisis." Prices fell so dramatically that many major oil companies and first-world banks were in danger of failure. Negotiations between the Saudi King and then vice-President G. W. Bush, ended in a set-price band, to be enforced by the Saudis acting as the oil-price "swing state." [6] This history is well-remembered in the oil sector, especially by al-Naimi and OPEC.

In the present circumstances, one finds simultaneously rising global supply and decelerating demand depressing prices.

On the demand side, the main driver of the past decade was Asian economic growth. While Asian demand will generally expand, its rate is slowing. In 2014, China experienced its lowest growth, 7.4%, in 24 years. So too, the EU has gotten itself into a low-growth, perhaps-deflationary mode. And, for Latin America, with growth dependent on commodity exports, China and the EU's situation augers protracted low growth. And, even though the USA economy is in recovery, its oil-use profile was transformed in recent years, with long-term oil demand plateauing.[7] In addition, low natural-gas prices gave a boost to fuel switching to natural gas-fueled vehicles in the OECD, and vehicle efficiency gains.

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[5] Al-Naimi interview with MEES (Middle East Economic Survey) in Abu Dhabi, as reproduced at: http://oilpro.com/post/9223/mees-interview-saudi-oil-minister-ali-naimi. Conducted 21 December 2014.

[6] An account of the crisis and negotiations is contained in: Yergin, Daniel; "The Prize: The Epic Quest for Oil, Money & Power," Chapter 36.

[7] T.W. O'Donnell, "Where's the demand for Latin America's oil boom?" http://globalbarrel.com/2011/12/17/a-santos-chavez-pipeline-wheres-the-demand-for-latin-americas-oil-boom/

On the supply side, since 2006, the USA has produced more new oil due to hydraulic fracturing technology than all the production removed from the market in Libya, Iraq, Iran and other Mideast and North African (MENA) states due to conflicts and sanctions. In many ways, this is fundamentally a story of technological innovation. However, protracted high prices enabled other marginal producers, including in Canada that developed Alberta's previously uneconomic "tar sands" extra-heavy oil; Brazil's national oil company, Petrobras, which developed new, deep-offshore "sub-salt" fields; and West-African states that developed new high-price-tag offshore projects. And, had prices remained high and Russia unsanctioned, complex and costly Arctic projects with western firm's know-how were on the agenda there to compensate for Western Siberia's decline. [Figures 3 & 4]

But, it is not only a matter of market fundamentals that brought prices down. In the futures market, the huge, speculative-driven price boosts seen before the Great Recession did not reoccur in mid-to-late 2014, even as ISIS advanced dramatically in Iraq, Libya's civil war flared, and Russian Arctic projects were undermined by sanctions. This is because new US laws restricting pure speculation in the futures market were now in place and had driven out big banks and major funds that would have flooded the futures market with cash in such circumstances, driving up prices.[8]

Lessons

Various lessons could be drawn from these circumstances. Although implications for Russia, Iran and Venezuela are very negative, this is not because the Saudis, the US or EU—at least in this instance—took aim at them. While their plights do derive from political decisions taken by their leaderships; the harsh reality is that, even if those decisions were to now be reversed, the trajectories of their outdated and poorly managed oil-sectors, increasingly uncompetitive in the 'big leagues' of today's high-tech and higher-efficiency marketplace, could only very gradually be reversed.

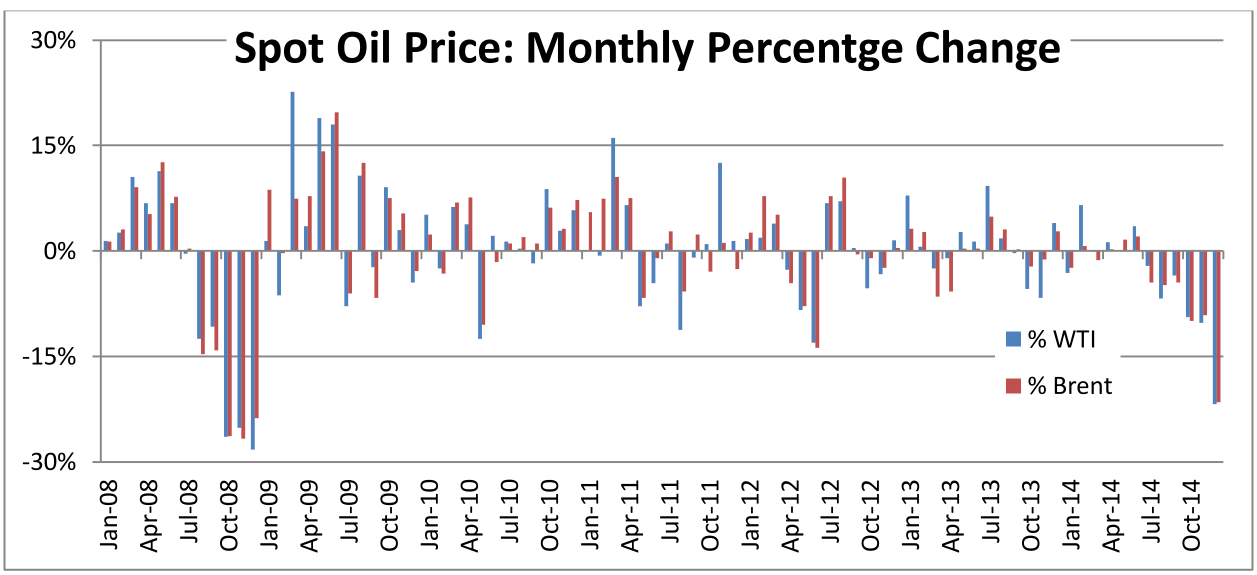

Figure 1: Month-on-month change in spot oil prices. Data: EIA, January 2015. (T O'D.)

[8] "Why oil prices that "should" be going higher are going lower?" http://us2.campaign-archive2.com/?u=ed58b19f2b88e4a743b950765&id=1582849c28&e=7faf4b2585

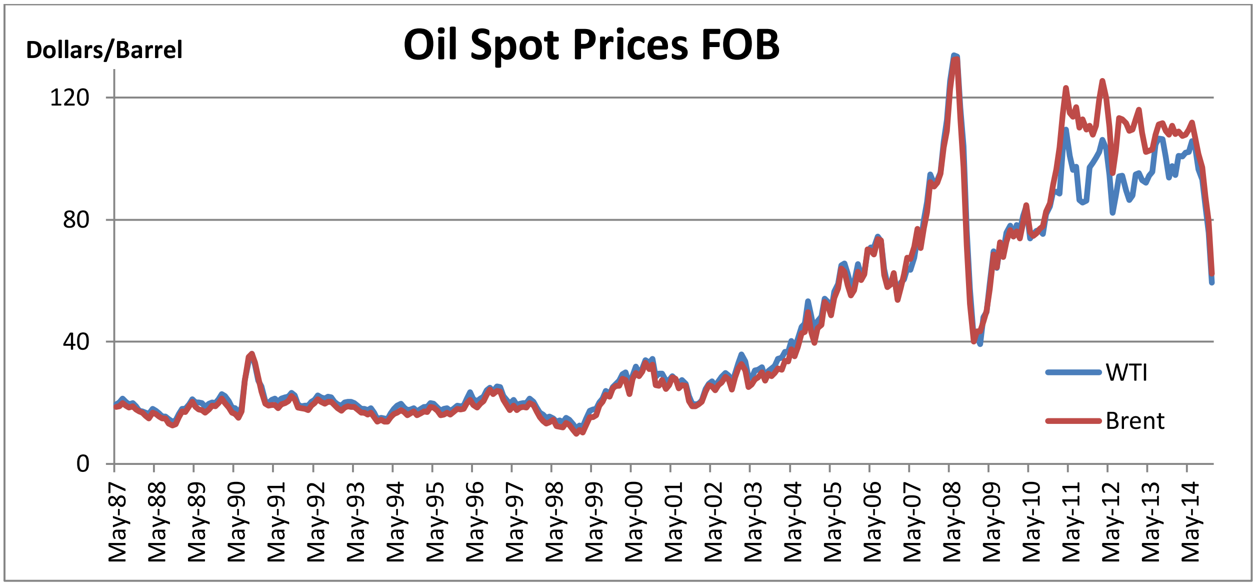

Figure 2: Oil spot prices (free on board), May 1987 - December 2014 at Cushing, OK (USA) and Brent (Europe). Source: EIA, January 2015 (T O'D.)

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Despite lower crude oil prices, U.S. crude oil production expected to grow in 2015

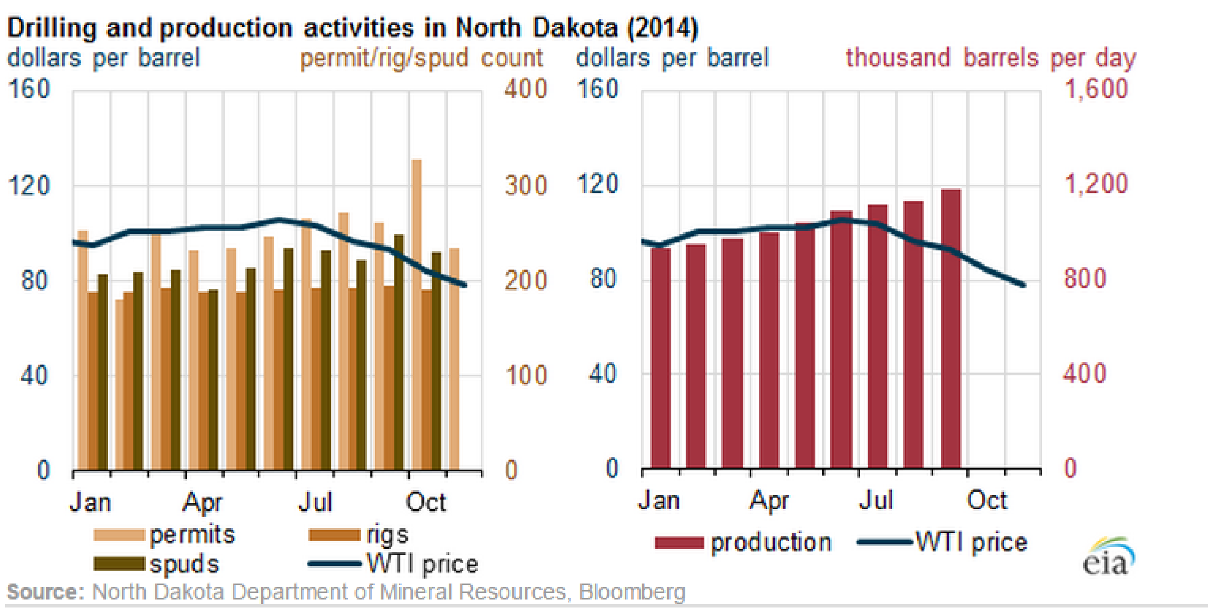

Figure 3: The US Energy Information Agency estimates that despite lower prices and many shale-oil fields becoming cost-prohibitive to produce, still US production will continue growing in 2015

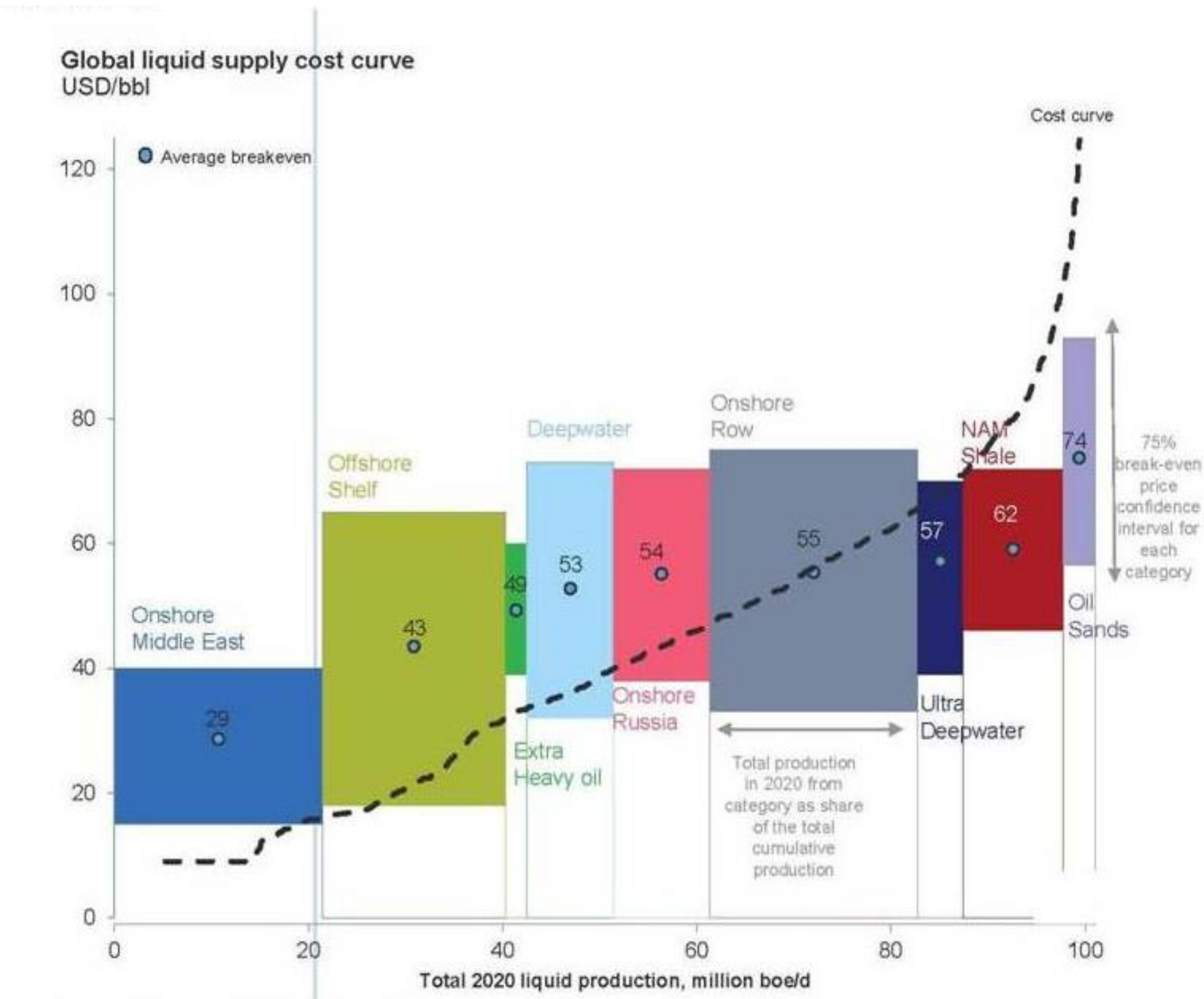

Figure 4 The horizontal axis shows the cost of production for major groups of oil fields today. Non-OPEC suppliers generally face much higher costs of extraction than the main OPEC producers. The dashed line represents the world marginal cost curve, showing how much it costs to produce an additional barrel by type of oil extraction in each case. The colored boxes represent a 75% confidence breakeven price for each. Source: IMF Blog, http://blog-imfdirect.imf.org/2014/12/22/seven-questions-about-the-recent-oil-price-slump/