Share versus Shale: The New Geopolitics of Oil

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Since August 2014, oil prices have continued to collapse. From a peak of $148 a barrel in 2008, prices temporarily levelled off at between $100-120 a barrel between 2009 and July 2014, before plummeting to around $30 a barrel in late December 2015, probably their last line of resistance. Given this overall price drop of about 70 to 75%, we are clearly dealing with an oil glut, comparable to those of 1982 and 1986.

The factors behind an oil glut vary from one crisis to the next. However, generally speaking, prices slump when oversupply coincides with sluggish demand. In contrast, an energy crisis occurs when demand outstrips supply, as happened in 1973, 1979 and 2008, pushing prices up in a way that is often further exacerbated by speculation and/or geopolitical shocks (such as the 1973 Arab-Israeli War, the Iranian Revolution in 1979, or the Gulf War in 1991), which intensify the bullish behaviour.

The collapse in oil prices in 2014-2015 is similar to previous oil gluts in terms of the underlying logic but differs from them in terms of the strategy followed by the major oil players. I am not referring to the baseless conspiracy theories that have flooded social networks and attribute the crisis to an American plot to weaken Russia, or to a Saudi manoeuvre to punish the kingdom's Iranian rivals, or even to a "Western plot" aimed at breaking OPEC and its grip on the oil market. Such speculations are completely unfounded. In reality, against a backdrop of mismatched supply and demand – due to the placing on the market of four million barrels per day (bpd) of shale oil in the US and flagging demand in China – it is a competition between Saudi Arabia and its American ally over market share. Hence, the title of this article: share versus shale.

A paradoxical crisis

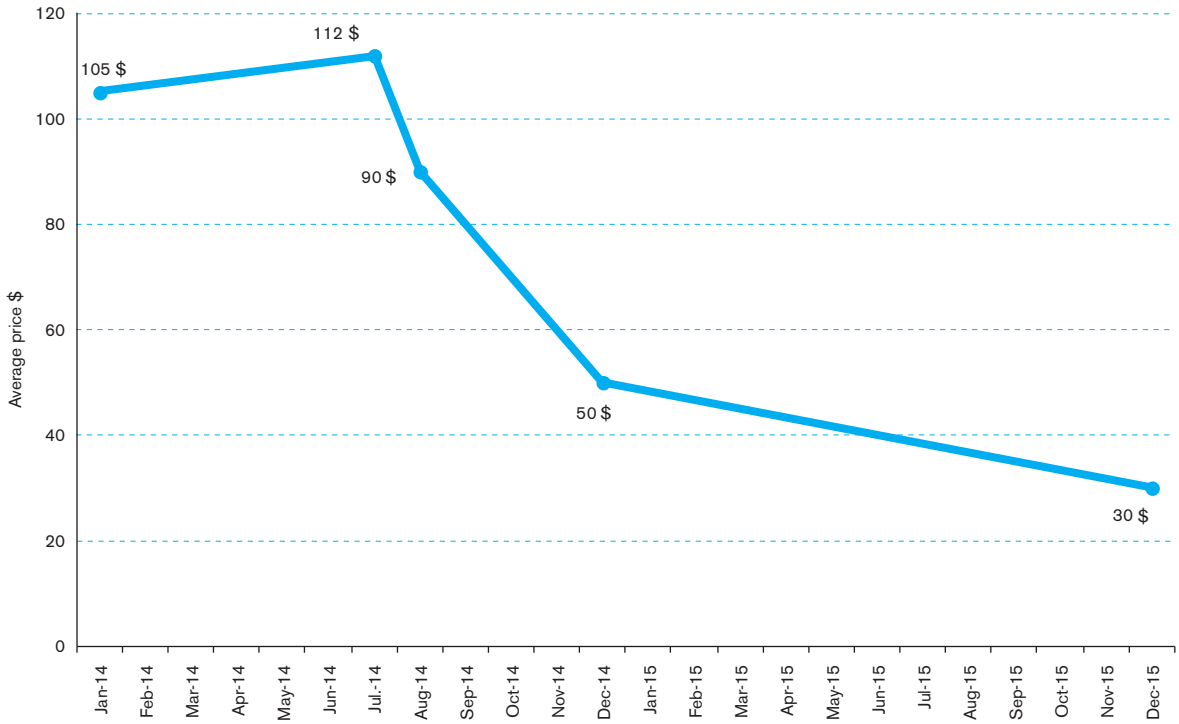
As with earlier crises, this one was preceded by five years of relative price stability. The paradox is that these prices were unusually high, in a way that was by no means justified by the anaemic state of the global economy following the subprime crisis. Moreover, the prices remained high even when supply outpaced demand by about one or two million bpd in the first three quarters of 2014, as shown in Chart 15.

It was not until August 2014 that prices began to fall. It would thus be wrong to think that the consistently high prices between 2008 and 2014 were due to economic factors alone (the global economy was sluggish) or geopolitical factors related to the crises in the Middle East. This would be to overlook the role of speculation in the exaggerated increase in prices and, especially, the boom in the production of unconventional oils between 2009 and 2014.

Indeed, shale oil exploitation has disrupted global oil geopolitics. In a short period of time, the US has come to place more than four million barrels per day on the market, as a result of exaggeratedly high oil prices that have allowed unconventional oil producers to invest heavily and make money. In short, it has been estimated that the average cost of production of new wells fluctuated between $45 and $70 with a profitability threshold in the range of $50 to $80 a barrel. Billions of dollars were thus quickly invested in new production, creating nearly 250,000 jobs.

These developments have caused concern in OPEC countries and their leader, Saudi Arabia. Whilst the production of non-OPEC countries rose from 52.76

CHART 15 **Average Oil Prices 2014-2015**



Source: The author.

million bpd in 2012 to 56.98 million bpd in 2015 (an increase of 4.22 million bpd), that of OPEC countries fell from a peak of 37.00 million bpd to just 35.93 million bpd over the course of the same period (a decline of 1.07 million bpd), as shown in table 10.

Saudi Arabia, the largest OPEC producer, is in a vulnerable position. Not only has it been challenged in its traditional markets, especially in Asia, by other producers, it is also being undermined by the placing on the market of millions of barrels per day of unconventional oil. Yet, with 16% of the world's proven oil reserves, only Saudi Arabia can play the role of "swing producer." This fact has earned it accolades from the International Monetary Fund, which has stated that Saudi Arabia has thus been able "to play a systematic and stabilizing role in the global oil market and contribute positively to global economic growth."[1]

However, at the OPEC meeting in November 2014, Saudi Arabia persuaded the other members to freeze the production ceiling despite the oversupply. In doing so, Saudi Arabia chose not to play its traditional role of "swing producer" and therefore declined to keep prices high, as they were enabling shale oil producers to gain market share. Certainly, the high prices between 2008 and 2014 allowed Saudi Arabia and other producers to reap vast revenues and inflate their sovereign wealth funds. However, this temporary gain harbingered a future loss in terms of market share. The old saying *short-term gain, future pain* seems appropriate here. It was oil prices in excess of $100 a barrel that made shale oil development possible. Saudi Arabia felt that it had indirectly "subsidized" the competition, to its own detriment.

Indeed, whilst US production increased 4.2 million bpd between 2008 and 2015, Saudi production increased by only one million bpd.

This dramatic jump in American production made it possible to reduce oil imports from 9.8 million bpd in 2008 to just 6.8 million bpd by the end of 2015, a decrease of 3 million bpd. This, of course, has impacted Saudi oil exports to the US, which fell by 350,000 bpd between 2008 and 2014.

[1] Cited in Naser Al-Tamimi, "Saudi Oil Policy: To Swing or Not to Swing… That's the Problem" in Valeria Talbot (ed.), *The Rising Gulf: The New Ambitions of the Gulf Monarchies*, ISPI, Milan, 2015, p. 81.

TABLE 10 **Non-OPEC and OPEC Production and Consumption (in million bpd)***

Year	2012	2015
Non-OPEC	52.79	56.98
OPEC	37.00	35.93
OECD consumption	45.90	45.87
Non-OECD consumption	43.24	46.63
Global consumption	89.14	92.50

* Sources: OECD and OPEC.

TABLE 11 **US and Saudi Production (in million bpd) 2008-2015 and Average Price (in dollars)**

Year	US	Saudi Arabia	Average price
2008	5.00	8.90	94.40
2015	9.40	9.80	30.00

Source: US Energy Information Administration.

TABLE 12 **Saudi Oil Exports (2008-2014) (in million bpd)***

	2008	2014	Change
US	1.503	1.159	**-23 %**
Japan	1.197	1.137	**-5 %**
China	0.730	0.997	17 %
India	0.527	0.711	35 %
South Korea	0.791	0.844	7 %
EU	0.283	0.323	14 %
Taiwan	0.340	0.287	**-16 %**
Singapore	0.342	0.188	**-45 %***

Complete table in Naser Al-Tamimi, "Saudi Oil Policy…," p. 88.

But what has really increased Saudi concern is the decline in Saudi exports to four of the country's seven main export markets due to competition from other producers, as shown in Table 12.

These developments shed light on the Saudi strategy to regain market share by cutting prices. With a production cost of less than $10 per barrel and an estimated sovereign wealth fund of $750 billion, Saudi Arabia can afford another seven years of $30 barrels. Few other producers, apart from the other Gulf emirates, can afford such a "costly choice."

However, Saudi Arabia is not only seeking to reclaim the crude market, it also aims to conquer the refining market. By multiplying the number of refineries in its territory, as well as its foreign joint ventures through partnerships with major companies (Sinopec, Total, Royal Dutch Shell, Exxon Mobil and others), Saudi Arabia had already built up an estimated refining capacity of 3.373 million bpd by the end of 2015. The Saudi company Aramco plans to increase this capacity to 8 million bpd in the coming years.

This strategic focus on refining has been coupled with a very wise and, to date, highly successful policy of developing petrochemical industries.

A Planned Decrease, Rather Than Simply an Oil Glut

As the above makes clear, the equation of supply and demand alone does not, in itself, explain the collapse in oil prices. The current decline in prices is mainly due to a twofold competition:

a) competition between Saudi Arabia and the US over unconventional oil and market share; and
b) competition between Saudi Arabia and other producers over the Asian markets.

That the Saudis, unhappy with their American ally, accused it of abandoning its Arab allies, such as President Mubarak of Egypt, of having put Iran back in the saddle after years of sanctions, and of having left the Syrian people to their sad fate is an open secret: the Saudis have said as much both publicly and in private. However, that disagreement does not explain the new Saudi oil strategy aimed at squeezing American shale oil out of the market.

The explanation for the decline in prices due to the geopolitical competition between Saudi Arabia and Iran is likewise of little relevance. Whilst it is true that

the two countries are engaged in a standoff in a tumultuous Middle East, that has less to do with oil strategies than with rivalry for regional hegemony.

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However, this rivalry could shatter the agreements to freeze production between the OPEC countries and Russia. Indeed, the Iranian Oil Minister Bijan Namdar Zanganeh has argued that his country has just come out of an embargo that has badly weakened its economy and that it needs to revive its oil exports in order to get its economy back on track. For the Iranian Oil Minister, the production freeze at 2015 levels is thus "a joke." "Why should we agree to freeze our production at one million barrels per day when others [i.e. Saudi Arabia] are producing 10 million barrels a day?" he asked bluntly.[2]

Iran's reasoning was not without merit, and it found some support amongst the other OPEC oil-producing countries, which called for the setting of new quotas in keeping with the member countries' needs. In contrast, Saudi Arabia, in the role of oil heavyweight, has argued that as a result of the decline in prices, oil production will necessarily fall into line with the market reality, oil demand will increase, and the OPEC countries will ultimately emerge reinvigorated.

Meanwhile, lower prices are producing a few winners and a lot of damage

Of course, the decline in prices has been a breath of fresh air for consumers, for some importing countries and even for some companies. A litre of diesel for less than a euro in Belgium or petrol in the US for just $2 a gallon (December 2015), down from $3.85 five years ago, is pretty good news. Companies are paying less for their fuel, households have seen their heating bills shrink, refineries are increasing their margins, and even airlines are coming out of the red. In 2015, Air France-KLM posted a profit of over €800 million, of which at least one third was due to lower oil prices.

Importing countries are also paying less for oil, which impacts their trade balance, GDP and growth. France saw its trade deficit fall from €74 billion in 2014 to €48 billion in 2015. The same was true for Belgium and Italy. Inflation in India, which imports 85% of the oil it consumes, stood at 6.5% at the end of 2015, compared to about 10-12% in previous years. Tunisia and Morocco, two Mediterranean importing countries, have likewise achieved substantial savings.

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In short, if one considers that a $70 drop in the price of a barrel of crude translates to a transfer of more than $2 trillion from oil-producing countries to oil-consuming countries, then clearly the oil crisis since August 2014 has entailed a restoration of purchasing power to the global economy as a whole equal to 2% of global GDP.

However, there is a flip side, and the biggest losers are the producing countries themselves. Tumbling prices exacerbate their vulnerabilities, hinder their growth, increase their deficits, and, should they continue, could ultimately lead to a breach of the social contract. Of course, not all countries are in the same

[2] www.albawaba.com/business/iran-says-assumption-they-would-freeze-oil-production-joke-809286

boat. In **Russia**, where gas is automatically linked to oil, the decline has reduced export earnings and affected the exchange rate, with the rouble, which was trading at RUB 30 to the dollar in 2010, trading at almost RUB 70 to the dollar today. Nevertheless, Russia is strongly positioned: foreign exchange reserves were equal to 11% of GDP at the start of 2015, public debt is low (9% of GDP) and only a small proportion (less than 3% of GDP) is held in foreign currency. Furthermore, the Russian banking system as a whole is more of a creditor than a debtor vis-à-vis the world. In short, Russia can weather the storm as long as it is temporary.

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Saudi Arabia recorded significant deficits of more than $90 billion in 2015. The other emirates were no better off. However, these Gulf countries have a combined population of about 40 million people and a financial cushion of nearly $2 trillion, which they can use to mitigate the impact of the decline for some years. Nevertheless, all these countries should rationalize energy consumption, increase petrol prices and introduce value-added tax.

The cases of **Iran**, **Indonesia**, **Nigeria**, **Venezuela** and **Algeria** are more problematic. These countries are more populous, and oil accounts for the bulk of their export earnings and a significant share of their GDP. Were the decline to last another year, there would be a real risk of sovereign default and social unrest. By way of example, **Venezuela**, where oil accounts for 90% of exports and 40% of government revenue, today stands at the brink, with 145% inflation. **Algeria**, which took advantage of the increase in oil prices between 2008 and 2014 to pay off its debt, is currently balancing on the razor's edge and has no choice but to tighten its belt, putting off infrastructure projects and trimming social spending. In short, all these producing countries are struggling to balance their budgets and keep their economies afloat.

Oil companies are likewise in trouble. It must not be forgotten that these companies make major investments accounting for almost a third of all investment spending by S&P 500 companies and that they account for 10% of S&P 500 earnings and 8% of the market capitalization. A decline in oil prices of this magnitude cannot help but impact their investment spending, turnover, profit, dividends and stock value. All of these companies have been forced to trim their sails and lay off workers. The companies involved in unconventional oil exploitation have been hard hit by a real risk of default, which, due to the potential domino effect, also affects the lending banks.

Perhaps the negative impact on economic growth in the US due to the decline in investment will be offset by an increase in consumption, but the eviction of unconventional oil from the market will be felt in terms of new energy dependence.

Future Outlook

Oil prices reached their resistance threshold at the end of 2015. It would be highly unlikely, not to mention detrimental to the global economy, for them to fall any further. Such a decline would spell disaster for all the producers lacking financial cushions. Additionally, the windfall for consumers could be short-lived, since oil demand is expected to rise again whilst investment in alternative energy will slow or be delayed. Ultimately, this would threaten not only energy security, but also environmental security.

Once the oversupply has been reabsorbed by growing demand and the disappearance of 'expensive oil,' prices will begin to climb. This trend will fluctuate due to the instability of the exporting regions. It is impossible to predict the price of a barrel in the coming years. One thing is certain: it will fluctuate between $30 and $45 until late 2016, but $100, let alone $120, barrels will remain out of reach for years. Barring a geopolitical cataclysm.