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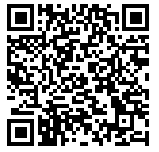

Written by Bob Adelmann on March 21, 2016
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Follow the Money? No, the Politics.

Oil: Cui Bono?

On January 22 Clifford Krauss, writing in the *New York Times*, claimed that the recent drop in crude oil prices can easily be explained by simple economics: Supply is overwhelming demand. End of discussion.

It's true that U.S. producers, despite having cut their rig count by 60 percent and having laid off an estimated 250,000 roughnecks in the nation's oil patch, continue to produce at levels barely off all-time record highs recorded last year. It's also true that Iran is planning to add some 500,000 barrels per day (bpd) to the glut, with some estimating that by summer new production from Iran will be closer to a million bpd. Deep-water projects begun years ago in the Gulf of Mexico will be coming online later this year as well.

Krauss is also correct in noting that increased automobile fuel efficiency and struggling European and Asian economies are reducing demand significantly.

As to trends likely to increase oil costs, he notes that more than 40 mid-sized independent U.S. oil producers have declared bankruptcy, with more to follow in April when banks recalculate reserve valuations and begin to call in loans made earlier that now exceed the banks' underwriting requirements.

If one were to stop there, one would be hard-pressed to explain why, in recent weeks, the price of crude has moved higher instead of trading closer to $25 and heading lower.

The Politics of Oil

Let's explore the reasons why, which have little to do with the price of oil and much to do with political decisions made by OPEC and opportunities being seized by Big Oil (BP, Chevron, ExxonMobil, Royal Dutch Shell, Total, and ConocoPhillips). It's helpful to remember that the decision made by Saudi Arabia in November 2014 to reject cutting oil production (which would have kept oil prices higher) was in order to "preserve market share" versus its competitors. Observers concluded that the Saudis, with their massive oil reserves (state-owned Saudi Aramco's assets beneath the sand are valued at an astounding $30 *trillion*, dwarfing the reserves of any other oil company on the planet), could easily outlast the American "cowboys" — the frackers who have upended the entire global oil and gas equation. Saudi Arabia, by letting (or driving) oil and gas prices lower, would force marginal producers into bankruptcy, with significant attendant reductions in production. Then the market would

"rebalance" itself in favor of the Saudis and the other members of the OPEC cartel, with crude headed above $50 a barrel.

Big Oil was looking forward to absorbing those failed or failing producers the way they did back in the 1990s. Remember that Royal Dutch merged with Shell to become Royal Dutch Shell; that Exxon merged with Mobil to become ExxonMobil; that Chevron acquired Gulf Oil in 1984, Texaco in 2000, and Unocal in 2005; and that Lukoil acquired Getty Oil in 2000.

But failure and decreased profits by U.S. oil producers are forcing the big banks financing Big Oil to set aside significant reserves to cover expected loan losses rather than help finance Big Oil with new acquisitions. Wells Fargo is sitting on more than $17 billion in loans to the oil-and-gas sector, and just announced it is setting aside $1.2 billion in loan loss reserves because of the "continued deterioration within the energy sector." JPMorgan Chase (JPM) is likewise setting aside hundreds of millions — perhaps as much as $750 million — to offset predicted (and predictable) losses this spring. JPM's chief financial officer, Marianne Lake, noted: "As the outlook for oil has weakened, we would expect to see some [additions to loan loss reserves] in 2016." Citigroup has set aside $300 million of its capital for loan loss reserves as well, noting that "oil prices are likely to remain low for a longer period of time."

This raises the question, just how long? If the price of oil stays around $30 a barrel, Citi could face $600 million in loan losses just in the next few months. If oil drops to $25 or lower, Citi's losses could double, to $1.2 billion.

That is a critical question for OPEC, Saudi Arabia in particular. There, oil production accounts for more than 60 percent of its GDP. In Kuwait, oil production is 72 percent of that country's GDP. By comparison, oil production in the United States is just 2.4 percent of GDP. If oil stays low, or goes lower, it will hardly move the needle in the United States, but in OPEC nations such as the UAE, Qatar, Algeria, Venezuela, and Ecuador the impact would raise existential concerns.

For venture-capital firms — sometimes called vulture-capital firms — such as Marathon Asset Management, low oil prices represent a breathtaking opportunity. Described as "focused on opportunistic investing" and with $13 billion in its coffers, Marathon is standing beside the road waiting for roadkill. Once in bankruptcy, smaller, overleveraged oil producers will have the debit side of their ledger wiped clean and Marathon can come swooping in, buy up what's left, revive them with a temporary infusion of investors' cash, and find new operators who then will continue to produce, but with much lower break-even points. OPEC didn't figure this: Marginal producers with hefty reserves in the ground will merely change hands but with lower break even points. That means they will continue to produce even if prices move lower.

There's the politics as well, with King Salman taking the reins in Saudi Arabia barely a year ago. Not only is he having to deal with the results of bad decisions in the past, he is making some bad ones of his own. William Engdahl, writing in *Global Research*, called his decision in early January to execute Nimr al-Nimr, a highly popular figure among the Shia minority, "insanely provocative," and reverberations of that act between the Shia and Sunni majority continue to threaten domestic tranquility today.

Another bad decision, according to Engdahl, was the naming by King Salman of his son Prince Muhammad as next in line to the throne. Quoting German BND intelligence services, the prince is "unpredictable and emotional," adding that with Salman's involvement in Syria, Lebanon, Bahrain, Iraq, and Yemen, "The previous cautious diplomatic stance of older leaders within the royal family is being

replaced by a new impulsive policy of intervention."

Also in the Middle East, there's the shooting down by Turkey of a Russian jet over Syria that successfully ended formal relations between Turkey and Russia. There's the determination by Iran to continue expanding its nuclear facilities, claiming that they're for domestic use as energy sources.

Talking Heads

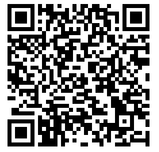
Analysts close to the oil markets (perhaps too close) have come up with all manner of excuses to explain the recent bump in crude prices: 1) a renewed possibility of production cuts, this time proffered by UAE's energy minister; 2) modest signs of falling production — very modest; 3) technical indicators showing those who believe in such things as Fibonacci retracements that oil will have to move higher, at least in the short run; and 4) the high volume of contracts traded on the New York Mercantile Exchange (NYMEX), with WTI (West Texas Intermediate) crude-oil contracts setting volume records, causing extreme market volatility.

In the short run, these "reasons" may have some substance. In the long run, they have none at all. There's much more to the equation than just supply and demand. With the United States' clandestine support of ISIS and al-Nusra (with the help of Israel, Great Britain, and Turkey), the Middle East remains a bomb with a lit fuse. As Dr. Hossein Askari, a former advisor to the Saudi Finance Ministry, stated:

If there is a war confronting Iran and Saudi Arabia, oil could overnight go to above $250 [a barrel].… If they attack each other's loading facilities, then we could see oil spike to over $500 and stay around there for some time, depending on the extent of the damage.

In that unhappy event, concerns about oil reflecting simple market supply and demand will evaporate in the face of much more serious matters.

Photo: AP Images



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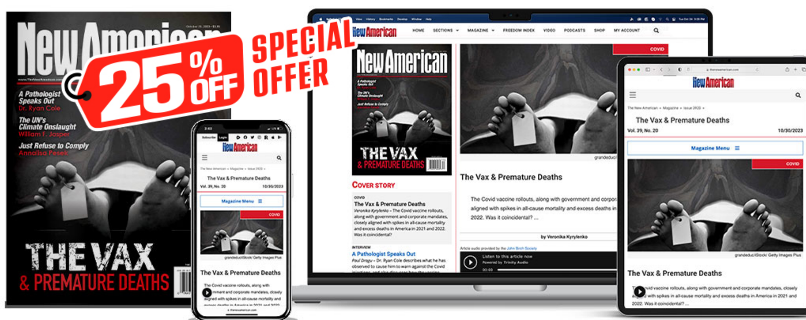

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