Crude Oil Prices: The Politics, Implications, and Backlash

With the price of crude dropping significantly below $50 a barrel, prognosticators have come out of the woodwork predicting drops to $40, $30, $20 a barrel, and even lower before it rebounds.

Jon Ogg, writing at 247Wall St.com, noted that the precipitous drop in crude oil prices "has serious implications for consumers and companies alike," and not all of them are unblemished blessings. On the surface the winners are consumers, who are enjoying the equivalent of a $750 annual tax cut thanks to the drop in gas prices at the pump.

The ripple effect bodes well, too, for airlines, over-the-road truckers, anyone using oil to haul freight or oil or natural gas to heat their homes, oil or natural-gas fired power plants, restaurants, retailers — just about every conceivable consumer product will be impacted favorably thanks to lower energy costs.

{modulepos inner_text_ad}

However, the "backlash" of those lower prices could be important, even significant, with some observers suggesting catastrophic impacts to the U.S. economy, just now recovering from the Great Recession. But in considering any potential economic backlash, it is helpful to remember that without the fracking boom, job growth would still be negative.

It is also helpful to remember that much of the fracking boom has been financed by investors seeking income while ignoring the downside risks. At present more than $200 billion in junk bonds has been issued by energy developers with another $300 billion loaned to them by banks. Some banks in the oil patch have 20 percent of their portfolios tied up in energy development loans — far higher than the banks' equity.

The derivatives market, estimated at more than $700 trillion worldwide, has major exposure to the energy market, which explains the interest those banks had in making sure that their derivatives exposure was backed up by the U.S. taxpayer in the recently-passed CRomnibus bill.

Marin Katusa, editor of the *Casey Energy Report*, was blunt:

> The nightmare for the US oil industry is that the only way that the market mechanism can eliminate the global oil glut … is if the price of oil falls below the "cash cost" of production, i.e., it reaches the price at which oil companies lose money on every single barrel they produce.

With crude at $48 a barrel and falling, it is coming perilously close to that "cash cost," which is estimated to be between $35 and $45 a barrel. Oil rigs are already being idled, and major players are cutting their capital expenditures for 2015.

A revealing case is Oasis Petroleum, which invested $1.4 billion drilling wells and bringing production on stream last year. This year Oasis just announced it will cut that number in half: to $750-850 million. In its forward guidance announcement, Oasis wrote: "Instead of growing production at a rate of 50% a year, Oasis is projecting 5-10% growth in 2015."

If this specific case is arbitrarily applied to the entire oil industry, production (which is currently running more than nine million barrels a day) would drop back to 8.4 million, a 700,000-BPD (barrels per day) decline. This contrasts with outlooks from the U.S. Department of Energy and the International Energy Agency, which predict a growth of up to 1.5 million barrels per day next year.

That's a "swing" of almost 2 million barrels a day, noted Jody Chudley, an advisor at Agora Financial. He added:

> Shale producers are responding immediately, and in a big way, to this oil price decline. And if there is one indisputable fact about shale production it's that with its very high rate of production decline [per well], a decrease in drilling will quickly show up in the production numbers.

The economics in the oil patch are fairly predictable. As demand from abroad declines while producers continue to produce, prices will fall further. The weakening economy in China, the fact that gasoline demand is "inelastic" (a drop in price doesn't necessarily cause drivers to drive more), the softening economy in Europe, the determination by the OPEC cartel to continue to produce at its maximum, all lead to lower prices. The bottom in crude will be found, in free market theory at least, when demand equals supply.

The politics, however, is vastly different. Back in September, Secretary of State John Kerry held a critically important meeting with the king of Saudi Arabia, allegedly to drum up support for U.S. attacks on the Syrian extremist group known as Islamic State. As the *Wall Street Journal* reported:

> At the palace, Secretary of State John Kerry requested assistance up to and including air strikes, according to U.S. and Gulf officials. "We will provide any support you need," the king said.
>
> That moment, more than any other, set in train the U.S. air campaign in Syria against Islamic State, according to U.S. and Gulf officials.…
>
> The [agreement] gave the Saudis leverage to extract a fresh U.S. commitment to beef up training for rebels fighting Mr. Assad [Syria's president], whose demise the Saudis still see as a top priority.

Who is supplying those rebels? Russia and Iran. Andrew Topf, writing in Reuters, noted the connection and the opportunity through lower oil prices — much lower oil prices — to punish both Russia and Iran:

> By opposing Syria, Abdullah [the king of Saudi Arabia] grabs the opportunity to strike a blow against Iran, which he sees as a powerful regional rival due to its nuclear ambitions, its support for militant groups Hamas and Hezbollah, and its alliance with Syria, which it provides with weapons and funding.
>
> The two nations are also divided by religion.…
>
> The conflict is now a full-blown proxy war between Iran and Saudi Arabia.

Since Iran needs oil in the area of $140 a barrel to continue funding its revolutionary efforts, lower oil prices put that country into a severe cash flow pinch. The fact that lower oil prices also pinch Putin is a bonus.

The danger in politics is that it runs by a different set of rules than does the free market, with potential consequences far beyond the sell-off in the junk bond market in the United States and the possibility that some in the oil patch will be seeking other employment.

One of those many prognosticators now hazarding guesses about the future of crude oil prices is Jeremy Warner of the *Sydney Morning Herald*. A year ago Warner correctly predicted the fall in oil prices to at least $80 a barrel, calling it "a surprisingly likely prospect, the implications of which have been largely missed by mainstream economic forecasters."

Riding his success with that call, he now predicts where oil might go from here:

> If on to a good thing, you might as well stick with it; so for the coming year I'm doubling up on this forecast. Far from bouncing back to the post crisis "normal" of something over $100 a barrel … my view is that the oil price will remain low for a long time, sinking to perhaps as little as $20 a barrel over the coming year before recovering a little.

Lower gas prices are not an unmixed blessing, especially with political maneuvering behind the scenes risking far more than just a shrinkage in the oil patch.

A graduate of an Ivy League school and a former investment advisor, Bob is a regular contributor to The New American *magazine and blogs frequently at www.LightFromTheRight.com, primarily on economics and politics.*