Written by **Bob Adelmann** on October 3, 2014

Saudi Arabia Cuts Oil Prices, Could Spark Price War

In a surprise move this week, Saudi Arabia cut the price of its flagship Arab light oil, which it sells mostly to its Asian customers, by one dollar a barrel. It also cut prices to its customers in the United States and Europe by $.40 a barrel. This brings Saudi Arabia's prices below those offered by OPEC member Qatar and non-OPEC member Oman. Oil futures traders are holding their breaths, waiting for Qatar and Oman to cut their prices in response, setting off a full-scale oil price war.

The simple economics of supply and demand have already driven the price of oil down by almost 20 percent since June, and a number of traders and other observers are suggesting those prices have much further to drop. Analyst John Kilduff of Again Capital said, "I think we're going to see the low $80s fairly quickly from here," while Fadel Gheit, a senior energy analyst at Oppenheimer, explained, "It's both supply and demand. It's basically the perfect storm that brought all prices down. You have plenty of supply, which you never thought possible, and all of a sudden, demand is shrinking: China is slowing down [and] Europe never recovered."

Gheit expects retaliation from other members of OPEC because that cartel, he says, "is held together by scotch tape. They hate each other." He says the members of the cartel are mostly interested in maintaining market share and because of that he sees crude oil prices falling in the longer term into the $70s.

The Energy Information Administration (EIA) predicts that crude oil production in the United States will rise next year to the highest level in nearly 50 years, while Goldman Sachs noted earlier this week that Russia's crude oil output has risen to nearly a post-Soviet era record. *Bloomberg* estimates that crude oil production from Kurdistan over the next 15 months will likely increase by more than China's increase in demand for oil over that period.

In the short run, that is having a positive impact on prices at the pump in the United States, which fell to an average of just $3.32 a gallon last week, the lowest price since February. More than half of the states have at least one gas station selling gas at less than three dollars a gallon.

If oil prices drop too far, however, production will be stymied. As Stephen Leeb, a writer at *Forbes*, put it, "It takes energy to get energy." In the early 1950s, it took the energy from 20 barrels of oil to harvest 100 barrels. Today, in conventional oil fields, it takes about one barrel to produce nine.

But the cost to discover, develop, and lift nonconventional oil — shale oil fracking — takes about one barrel to produce four barrels. According to State University of New York Professor Charles Hall, the energy from one barrel of oil must recover a minimum of five barrels to allow a modern industrial society such as America's to grow and thrive and prosper. In other words, if the price of crude does drop to $70 barrel and stay there for an extended period, energy exploration companies will have little incentive to discover and develop additional resources.

At present, American drivers are enjoying the savings at the gas pump and those savings are being spent elsewhere, helping the economy to continue to recover, albeit slowly, from the Great Recession. In the energy business, nothing happens in a straight line, and any dampening to America's remarkable record-setting production due to low prices remains several years in the future.

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