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Oil prices have fallen by half since late June. This is a significant development for the oil industry and for the global economy, though no one knows exactly how either the industry or the economy will respond in the long run. Since it's almost the end of the year, perhaps this is a good time to stop and ask: (1) Why is this happening? (2) Who wins and who loses over the short term?, and (3) What will be the impacts on oil production in 2015?

1. Why is this happening?

Euan Mearns does a good job of explaining the oil price crash [here](#). Briefly, demand for oil is softening (notably in China, Japan, and Europe) because [economic growth is faltering](#). Meanwhile, the US is importing less petroleum because domestic supplies are increasing—almost entirely due to the frantic pace of drilling in "tight" oil fields in North Dakota and Texas, using hydrofracturing and horizontal drilling technologies—while demand has leveled off.

Usually when there is a mismatch between supply and demand in the global crude market, it is up to Saudi Arabia—the world's top exporter—to ramp production up or down in order to stabilize prices. But this time the Saudis have refused to cut back on production and have instead unilaterally cut prices to customers in Asia, evidently because the Arabian royals *want* prices low. [There is speculation](#) that the Saudis wish to punish Russia and Iran for their involvement in Syria and Iraq. Low prices have the added benefit (to Riyadh) of shaking at least some high-cost tight oil, deepwater, and tar sands producers in North America out of the market, thus enhancing Saudi market share.

The media frame this situation as an oil "glut," but it's important to recall the bigger picture: world production of conventional oil (excluding natural gas liquids, tar sands, deepwater, and tight oil) [stopped growing in 2005](#), and has actually declined a bit since then. Nearly all supply growth has come from more costly (and more environmentally ruinous) resources such as tight oil and tar sands. Consequently, oil prices have been very high during this period (with the exception of the deepest, darkest months of the Great Recession). Even at their current depressed level of \$55 to \$60, petroleum prices are still above the [International Energy Agency's high-price scenario](#) for this period contained in forecasts issued a decade ago.

Part of the reason has to do with the fact that costs of exploration and production within the industry have risen dramatically (early this year Steve Kopits of the energy market analytic firm Douglas-Westwood estimated that [costs were rising at nearly 11 percent annually](#)).

In short, during this past decade the oil industry has entered a new regime of steeper production costs, slower supply growth, declining resource quality, and higher prices. That all-important context is largely absent from most news stories about the price plunge, but without it recent events are unintelligible. If the current oil market can be characterized as being in a state of "glut," that simply means that at this moment, and at this price, there are more willing sellers than buyers; it shouldn't be taken as a fundamental or long-term indication of resource abundance.

2. Who wins and loses, short-term?

Gail Tverberg does a great job of teasing apart the likely consequences of the oil price slump [here](#). For the US, there will be some tangible benefits from falling gasoline prices: motorists now have more money in their pockets to spend on Christmas gifts. However, there are also perils to the price plunge, and the longer prices remain low, the higher the risk. For the past five years, tight oil and shale gas have been significant drivers of growth in the American economy, adding \$300 to 400 billion annually to GDP. States with active shale plays have seen a significant increase of jobs while the rest of the nation has merely sputtered along.

The shale boom seems to have resulted from a combination of high petroleum prices and easy financing: with the Fed keeping interest rates near zero, scores of small oil and gas companies were able to take on enormous amounts of debt so as to pay for the purchase of drilling leases, the rental of rigs, and the expensive process of fracking. This was a tenuous business even in good times, with many companies subsisting on re-sale of leases and creative financing, while failing to show a clear profit on sales of product. Now, if prices remain low, most of these [companies will cut back on drilling and some will disappear altogether](#).

The price rout is hitting Russia quicker and harder than perhaps any other nation. That country is (in most months) the world's biggest producer, and oil and gas provide its main sources of income. As a result of the price crash and US-imposed economic sanctions, the ruble has cratered. Over the short term, Russia's oil and gas companies are somewhat cushioned from impact: they earn high-value US dollars from sales of their products while paying their expenses in rubles that have lost roughly half their value (compared to the dollar) in the past five months. But for the average Russian and for the national government, these are tough times.

There is at least a possibility that the oil price crash has important geopolitical significance. The US and Russia are engaged in what can only be called low-level warfare over Ukraine: Moscow resents what it sees as efforts to wrest that country from its orbit and to surround Russia with NATO bases; Washington, meanwhile, would like to alienate Europe from Russia, thereby heading off long-term economic

integration across Eurasia (which, if it were to transpire, would undermine America's "sole superpower" status; [see discussion here](#)); Washington also sees Russia's annexation of Crimea as violating international accords. [Some argue](#) that the oil price rout resulted from Washington talking Saudi Arabia into flooding the market so as to hammer Russia's economy, thereby neutralizing Moscow's resistance to NATO encirclement (albeit at the price of short-term losses for the US tight oil industry). [Russia has recently cemented closer energy and economic ties with China](#), perhaps partly in response; in view of this latter development, the Saudis' decision to sell oil to China at a discount could be explained as yet another attempt by Washington (via its OPEC proxy) to avert Eurasian economic integration.

Other oil exporting nations with a high-price break-even point—notably Venezuela and Iran, also on Washington's enemies list—are likewise experiencing the price crash as economic catastrophe. But the pain is widely spread: Nigeria has had to redraw its government budget for next year, and [North Sea oil production is nearing a point of collapse](#).

Events are unfolding very quickly, and economic and geopolitical pressures are building. Historically, circumstances like these have sometimes led to major open conflicts, though all-out war between the US and Russia remains unthinkable due to the nuclear deterrents that both nations possess.

If there are indeed elements of US-led geopolitical intrigue at work here (and admittedly this is largely speculation), they carry a serious risk of economic blowback: the oil price plunge appears to be [bursting the bubble in high-yield, energy-related junk bonds](#) that, along with rising oil production, helped fuel the American economic "recovery," and it could result not just in layoffs throughout the energy industry but a contagion of fear in the banking sector. Thus the ultimate consequences of the price crash could include a global financial panic ([John Michael Greer makes that case persuasively](#) and, as always, quite entertainingly), though it is too soon to consider this as anything more than a possibility.

3. What will be the impacts for oil production?

There's actually some good news for the oil industry in all of this: costs of production will almost certainly decline during the next few months. Companies will cut expenses wherever they can (watch out, middle-level managers!). As drilling rigs are idled, rental costs for rigs will fall. Since the price of oil is an ingredient in the price of just about everything else, cheaper oil will reduce the costs of logistics and oil transport by rail and tanker. Producers will defer investments. Companies will focus only on the most productive, lowest-cost drilling locations, and this will again lower averaged industry costs. In short order, the industry will be advertising itself to investors as newly lean and mean. But the main underlying reason production costs were rising during the past decade—declining resource quality as older conventional oil reservoirs dry up—hasn't gone away. And those most productive, lowest-cost drilling locations (also known as "sweet spots") are limited in size and number.

The industry is putting on a brave face, and for good reason. Companies in the shale patch need to look profitable in order to keep the value of their bonds from evaporating. Major oil companies largely stayed clear of involvement in the tight oil boom; nevertheless, low prices will force them to cut back on upstream investment as well. Drilling will not cease; it will merely contract (the number of new US oil and gas well permits issued in November [fell by 40 percent from the previous month](#)). Many companies have no choice but to continue pursuing projects to which they are already financially committed, so we won't see substantial production declines for several months. Production from Canada's tar sands will probably continue at its current pace, but will not expand since new projects will [require an oil price at or higher than the current level](#) in order to break even.

As [analysis by David Hughes of Post Carbon Institute](#) shows, even without the price crash production in the Bakken and Eagle Ford plays would have been expected to peak and begin a sharp decline within the next two or three years. The price crash can only hasten that inevitable inflection point.

How much and how fast will world oil production fall? [Euan Mearns offers three scenarios](#); in the most likely of these (in his opinion) world production capacity will contract by about two million barrels per day over the next two years as a result of the price collapse.

We may be witnessing one of history's little ironies: the historic commencement of an inevitable, overall, persistent decline of world liquid fuels production may be ushered in not by skyrocketing oil prices such as we saw in the 1970s or in 2008, but by a price crash that at least [some pundits are spinning as the death of "peak oil."](#) Meanwhile, the economic and geopolitical perils of the unfolding oil price rout make expectations of business-as-usual for 2015 ring rather hollow.