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The Perils of Cheap Oil

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The price and availability of oil affects all of us. From fuels to fertilizer to building materials, the number of everyday products is endless. Until we come up with a way to capture carbon dioxide from the atmosphere and convert it into fuels, oil is here to stay, as perhaps the most important resource needed to maintain our standard of living and improve the wellbeing of the developing world. The world produces 93 million barrels of oil per day, 34% of which comes from the 13-member OPEC cartel - followed by Russia (12%), and US (10%). A 1.5 million per day surplus of crude has been in place for more than a year – causing a global pricing collapse.

Global oil prices (US dollars) peaked in June 2014. In November that year, OPEC approved a Saudi motion to keep oil production unchanged, in spite of a weakening market caused by excess production. During the following 14 months, oil prices declined from $85 to $35. The irony is that OPEC could have engineered a 1.5 million pullback to stabilize the market - a 5% cut would have prevented a 59% revenue collapse.

There has been speculation that Saudi Arabia has engineered a drop in oil prices to shut down US oil producers that need $50 oil to pay lenders and bond holders. Those producers represent one-half of domestic production or 5.5 million barrels per day. But a more plausible reason is based upon Saudi Arabia's conflict with Iran and Russia over Syria and more recently Yemen. In short, Saudi Arabia wants to call the shots in this oil rich part of the world and eliminate Iran and Russia's influence. By bringing oil prices well below $100, Saudi Arabia is attempting to bankrupt its enemies fighting in the region.

Consumers are loving $2 gasoline and are in fact driving 3.5% more than in 2014. While oil companies are suffering, the other nine economic sectors are benefitting from lower energy costs. For now, there will be a positive wealth effect. This is giving consumers world-wide a $7.8 billion tax cut every day (WSJ 1/8/16). Not only are heating bills lower, but as petro chemical prices fall with oil, the cost of fertilizer, plastics, fabrics, resins, paint and just about everything else gets cheaper. But what happens in three years when global oil production begins a precipitous decline? It takes five to ten years to identify, evaluate, engineer and drill new oil fields. Deep off-shore projects take the longest. Energy companies are laying off geologists, engineers, welders, electricians, painters, pipefitters, and field hands. Unused drilling rigs are piling up in empty fields.

As world demand for oil approaches over 100 million barrels per day in the next five years, less production will be available from friendly regions around the world. By that time, Saudi Arabia may be in the midst of a full blown war with Iran (and Iraq). The other Saudi friendly Persian Gulf states may not have protection. The developed world, along with the emerging powers of China and India are at great risk today that oil supplies may be disrupted in the near future. This uncertainty causes nations to prepare for war.