Exploding World, Cheap Oil

Geopolitical crises abound, but oil producers are still pumping -- and pumping more than the world needs.

BY KEITH JOHNSON

Here's a bit of a puzzler. The world is in flames, with an Islamist terrorist group on the rampage across the Middle East, the White House weighing another fight in Iraq, Russia and Europe still trading sanctions and salvos, Yemen imploding, North Africa reeling from one mess to another, and, as if that weren't enough, a deadly fever spreading exponentially in Africa. Yet oil prices keep falling and are now at their lowest levels in more than a year.

But the markets aren't crazy: Simple supply and demand are at play. The world's economy, especially in Asia, has hit a brick wall, which has dented the growth in demand for oil, pushing it down to levels last seen during the Great Recession.

On top of that, oil producers have kept pumping. The United States has added more than 3 million barrels daily in the last three years, and the annual jump in U.S. oil production just set a record. OPEC producers have been running full tilt, even Libya, which doesn't even have a functioning government, and Saudi Arabia, which used to act as the voice of reason to keep oil markets more or less balanced. Only in August did the Saudis start to dial back oil production, only partially offsetting surprising supply increases elsewhere.

The result: a glut of oil that has driven down benchmark crude prices to levels last seen at the beginning of 2013. Brent crude in London traded at about $97 a barrel Thursday, Sept. 11, while West Texas Intermediate, traded in New York, threatened to dip into the high $80s per barrel.

"If ever there were a geopolitical world that should be driving oil prices higher, it would seem to be right now," said Daniel Yergin, vice chairman of energy consultancy IHS and
author of The Quest: Energy, Security, and the Remaking of the Modern World. "But what it tells you is how powerful the fundamentals of the market are, and right now the fundamentals are winning out."

The big question is whether cheaper oil represents a short-term hiccup or a long-term, fundamental change, which could have big implications for petrostates in the Middle East, Africa, Latin America, and Europe, not to mention would-be petrostates such as Scotland and the Kurdish region of Iraq.

Rather than asking why oil prices are falling given all that's wrong in the world, it might make more sense to ask whether all the world's troubles are the only thing keeping crude prices from collapsing.

The global economy can't seem to find the recipe for consistent growth: Japan's horrific 7 percent contraction in second-quarter GDP may be extreme, but other Asian economies are also standing on the brakes. China's year-on-year demand for oil (and other raw materials) is essentially flat, sending prices for oil, iron, and other basic commodities plunging. Europe is no help, even without worries of what the Russian bear will do next. Next to all of them, the U.S. economy (and its need for oil) looks almost robust. But even U.S. oil demand is at or below the average of the last five years -- a dismal half-decade, for sure.

"It's a demand-led slowdown, and the extra supply is just adding to the bearishness," said Amrita Sen, oil analyst at Energy Aspects consultancy in London. "It's very hard to see how we come out of this anytime soon."

Citing the sluggish economy, OPEC dialed back its expectations of global oil demand for this year and next in its latest monthly report. So did the International Energy Agency in its monthly oil report. "The recent slowdown in demand growth is nothing short of remarkable," the IEA said Thursday.
And the U.S. Energy Information Administration (EIA) on Tuesday tweaked its outlook for oil prices to reflect the new market dynamics. In the reference case, the EIA now expects prices to stay below $100 a barrel until early in the next decade. Even when prices rebound, the EIA slashed its estimate for how high crude will go -- to just $141 a barrel by 2040, rather than the $165 predicted just last year. If global economic growth remains sluggish, the EIA sees oil prices stuck below $75 a barrel for decades to come.

Price fluctuation concerns everyone who pumps or burns oil, especially states -- such as those in the Middle East, Russia, and parts of Latin America -- relying on steadily rising oil prices to keep their economies afloat and their people pacified.

"If we are going to be in a weaker price environment, that certainly hits at the revenue assumptions on which a number of countries are running their economies and running their political systems," Yergin said.

Iraq, which is 93 percent reliant on oil for the government's income, needs crude at or above $106 a barrel to balance its budget; slipping prices already prompted a warning from the IMF this summer. Many other OPEC countries, from Iran to Nigeria, are in the same boat.

Russia needs to fetch $114 a barrel to stay in the black; what's more, if Moscow wants to maintain oil output by tapping tough but promising reserves in places like the Arctic, it needs oil to be expensive. Even Canada needs high oil prices to make the economics of extracting crude from tar sands -- a tricky business -- to work.

Lower prices wouldn't hurt just established producers. Kurdistan and Scotland, which are hoping to turn black gold into independence, stand to lose too. Baghdad isn't sharing oil revenue with Iraqi Kurdistan anymore, making it dependent on turning its ample oil reserves into sales in order to make up the difference. Iraqi Kurdistan's modest ambitions of selling 400,000 barrels a day are being sorely tested by a gun-shy market
now. How it would sell even more to account for declining prices is unclear.

Meanwhile, Scotland's dreams of independence from the United Kingdom will be determined by a referendum on Sept. 18. A Scottish state's viability hinges almost entirely on the question of how much oil is left in the North Sea and how much it will fetch.

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