Note to World: Alleged Oil Shock Isn't All That Shocking

Oil prices have fallen sharply. But that doesn't mean that oil is cheap -- and it doesn't spell doom for everybody.

BY KEITH JOHNSON

Crude oil prices in New York and London kept falling early Thursday, Oct. 16, sending the price of oil back to those long-ago, halcyon days of 2010 and prompting an orgy of hand-wringing about how cheap oil spells doom and despair for everybody from Vladimir Putin to Texas wildcatters. But does it?

Oil's recent slide, from prices around $115 a barrel over the summer to the low $80s today, has unleashed a torrent of speculation about what it all means. The New York Times' Thomas Friedman imagines that the United States and Saudi Arabia are conspiring to cripple oil-dependent Russia and Iran; energy-industry advisor Nick Butler worries that the Saudis have lost control of the oil market; all sorts of folks are gaming out the decline and fall of petrocracies from the Persian Gulf to Maracaibo; and analysts are scratching their heads to figure out if and when falling prices will kill the U.S. oil boom. And if the United States does reach a deal with Iran on that country's nuclear program and eases current restrictions on Iranian oil exports, that could push prices even lower.

In reality, what has happened is that froth has come out of a pricey oil market that simply had too much supply chasing anemic demand in a wheezing global economy. Falling oil prices don't necessarily mean cheap oil prices; in real-dollar terms, oil has only been this expensive for a half-dozen years or so since the end of the U.S. Civil War.

After early declines, oil in New York traded around $82 a barrel at midday, and oil in London at around $84 a barrel.
"This entire situation is a case of people coming to far broader conclusions than the limited amount of data out there warrants," said Michael Levi, an energy expert at the Council on Foreign Relations and the author of The Power Surge.

Lower, if not cheap, oil prices do potentially have some implications: good, bad, and indifferent. For consumers, falling prices are a good thing. For dysfunctional petrostates, like Venezuela, cheaper oil aggravates existing woes like squeezed federal budgets and fears of default. For flush petrostates, like Saudi Arabia, $80 oil does not spell hair shirts. And thanks to rapid increases in drilling efficiency, U.S. tight-oil producers have more protection against softening prices than they did just a few years ago, making it unlikely that today's prices will rabbit-punch the industry's surprise story.

Start with consumers: Cheaper oil prices means lower prices at the pump and for everything that is ever shipped, from food to flip-flops. The recent fall equates to a massive, unplanned stimulus package for the world's shoppers. Citigroup, for instance, figures that cheaper prices amount to a $1.1 trillion global shot in the arm. Others liken cheaper oil to a spontaneous round of global, quantitative easing -- an injection of easy money into a moribund economy.

Now, what about the basket cases? Falling oil prices mean falling government revenues for lots of countries that rely on oil exports to pay the bills. For a country like Venezuela, that's terrible news because the logical recourse -- printing more money -- would only fuel the runaway inflation that is wrecking the country’s economy already. Then again, the epic economic mismanagement by former President Hugo Chávez and current President Nicolás Maduro means that oil-market fluctuations simply aggravate an already bad situation, rather than create it: When your economy is out of toilet paper and toothpaste, you have deeper problems than the price of oil in London.
Russia is a different matter. Its budget loses about $2 billion for every $1 drop in the price of a barrel of oil. Anything below $104 a barrel, by some estimates, will push the Russian budget into the red. And that comes on top of U.S. and Western sanctions, which have mauled the ruble and the Russian stock market and have spooked foreign capital.

But budget deficits, as former U.S. Vice President Dick Cheney famously noted, don't mean demise. Five years ago, when oil prices plunged with the global recession, Russia ran a hefty budget deficit. Apparently that didn't permanently hamstring its leaders, its military, or its ability to make mischief in nearby countries. What's more, Russia's economic woes, paradoxically enough, insulate it against some of the oil-market pain. As Levi notes, the drop in the value of Russia's currency versus the dollar limits Moscow's budgetary pain; it's a bit easier to pay bills in devalued rubles.

But what about the big producers in the Middle East? It's true that in the wake of the Arab Spring, countries such as Saudi Arabia, Kuwait, and the like have heftier obligations than they used to: It takes plenty of cash to pacify restless domestic populations and prop up welfare states. That's why the so-called break-even fiscal prices for Gulf states have soared from the $60s a few years ago to about $90 today.

Some Saudis are worried about falling prices and the kingdom's seemingly blasé attitude. Prince Alwaleed bin Talal, a Saudi billionaire investor, criticized the Saudi oil minister and warned that it is a "catastrophe" to not take falling oil prices seriously.
Some Saudis are worried about falling prices and the kingdom's seemingly blasé attitude.

But as with Russia, the specter of lower prices doesn't necessarily mean government downfall. It means that countries swimming with hard-currency reserves and next to no debt might have to run deficits for a little while, as they've done before. Saudi Arabia, for instance, has three-quarters of a trillion dollars in its piggy bank.

In fact, producers like Saudi Arabia seem so comfortable with falling prices that it has sparked concern that OPEC's heavyweights are deliberately trying to push down oil prices enough to drive some expensive U.S. oil production offline. Gulf oil officials told the Wall Street Journal they'll oppose any oil-production cuts at November's OPEC meeting, and they pointed to $70 a barrel as a likely perch for oil prices.

Is there an orchestrated plan to make U.S. oil production uneconomic, and will it work? Although big, flush OPEC producers have so far -- mostly -- shrugged at falling prices, it's doubtful that the price decline is all their doing. The collapse in global oil-demand growth, thanks to the dismal economy, is likely responsible for that.

"If you want to permanently kneecap U.S. shale, you have to keep expanding your production massively for the next 10 years, and Saudi Arabia has shown no interest in doing that," Levi said.

More to the point, with crude prices in New York hovering around $80 a barrel Thursday, is the U.S. tight-oil boom in trouble at any event? Probably not.

The International Energy Agency noted this week that the overwhelming majority of U.S. tight-oil production -- that's crude produced by fracking -- will keep pumping with oil at $80. Only 4 percent of U.S. tight oil requires oil prices above $80, the International Energy Agency said.
And if the price of oil keeps falling toward the magical $70 figure at which Gulf officials now point? Analysts are all over the map when they try to figure out what kind of tolerance U.S. producers have. Some say U.S. tight oil will be fine down to $75 a barrel; others, like oil-services company Baker Hughes, figure that most U.S. projects will be fine with oil in the $60-to-$70 range. Still others argue that U.S. tight oil can remain economic with oil as low as $50 a barrel.

It is hard to come up with a single price point for U.S. tight oil due to the nature of unconventional oil production, which is very different from the large-scale, long-term output from big oil fields in the Middle East. Every independent producer has different costs for drilling and operating wells, and different shale plays offer different levels and costs of production. Some companies have more cash and can weather softer prices for longer; some could switch back to natural gas production as a chilly winter nears.

The one thing that is generally certain is that the cost of producing U.S. tight oil has fallen sharply -- and keeps falling. A Morgan Stanley analyst estimated that costs per barrel overall may have fallen as much as $30 a barrel in just the last two years, thanks to advances in fracking that make it cheaper and easier to get more oil out of each well drilled into the rock.

All that leaves a whole lot more wiggle room to deal with falling prices. And even if falling prices dampen oil companies' enthusiasm for expensive and risky new projects, it makes it unlikely that this autumn's oil-price correction will somehow shutter hundreds of thousands of barrels of U.S. production.

"Certainly it will deter risk-taking in new areas," said Levi. "But the last thing to go is actual drilling using existing assets."

Photo by Yasser al-Zayyat - AFP - Getty