# Trend Reversal in Oil Markets?*


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In early June 2016, the price of US West Texas Intermediate (WTI) crude oil crossed the $50-a-barrel mark for the first time since July the previous year, having risen from lows of around $25 a barrel in February. A gradual reversal of the previous steep decline had begun. This had set off speculation that the world economy is entering a new phase of the oil-cycle with prices expected to touch upward of $60-a-barrel by the end of the year. Interestingly, there were two different interpretations of the factors underlying this turn. Some argued that this was evidence of a demand revival that is tightening markets, even though other evidence suggested that the world economy is still steeped in recession. Others held that this showed that the Saudi Arabian strategy of not cutting production and supply in order to halt the price decline had worked. Prices were on the rise because the decline had wiped out non-competitive producers, especially in the US.

News of the breach of the $50-a-barrel psychological barrier came at a time when OPEC members were meeting in Vienna for their routine discussions on a common production strategy. That summit was seen as important because in an earlier meeting at Doha in April, OPEC members could not come to any agreement on holding back production to correct for low prices that were hurting exporting nations dependent on oil and gas for both revenues and foreign exchange earnings that financed crucial imports. These developments had once again triggered a debate on whether the “OPEC era” had ended.

It is indeed true that periodic disagreements on production sharing and violations of sharing agreements by some producers had made OPEC less effective as a cartel setting prices, than its image suggested it was. The cartel had seen a weakening of its influence on global prices in the past as well. With this latest round of price declines, it was being suggested that differences within the cartel meant it had lost even its limited influence because of the rise of the US as an oil major that would turn net exporter in a couple of years.

There were many reasons for the lack of a consensus on production cuts by OPEC members at Doha. Principally, Saudi Arabia, attributing the decline in global oil prices to increased American production of shale and traditional oil, had refused to cut production for fear of losing out on market share to the US. Its argument was simple. Encouraged by the earlier highs of $100 plus-a barrel the price of oil had reached, non-traditional sources like shale oil and gas had turned cost-effective, resulting in a surge in US production. The resulting global over supply was seen as having driven oil prices down. But rather than cut production to reverse the price fall, Saudi Arabia argued that the fall was a way in which markets were correcting for excess supply by forcing more expensive sources out of production. If OPEC members and Saudi Arabia in particular were to serve as “swing” producers who adjusted (in this case cut) production in order to stabilize prices, they would be giving up market share in favour of US producers, of high-cost shale in particular, in order to restore prices. This Saudi Arabia was unwilling to accept.

The depressing effect that the increase in US production and the refusal of Saudi Arabia to play its role as the traditional swing producer had on prices was aggravated by the end of US sanctions against Iran, after the agreement on the nuclear issue. Having lost out on trade opportunities in the past because of these sanctions, Iran was keen on regaining lost ground by expanding production and exports of oil. This brought into the market a hitherto absent, or near-absent, supplier with considerable reserves, and sent prices further downwards. According to the International Energy Agency, Iran’s production rose to 3.6 million barrels per day in April, returning to production levels last reached in November 2011.

In the circumstances, it was unclear whether Saudi Arabia’s strategy was paying off, with prices remaining low and exports below earlier levels. Besides Iran’s entry, two other factors

played a role in keeping prices low. The first was that, having borrowed hugely to create "fracking" capacities to extract shale oil and gas, companies in the US were not willing to cut back production and accept zero revenues because that would spell default and bankruptcies. They sought to remain in production for as long as possible, even though oil prices were not covering costs in full. It was only when recurring costs (as opposed to fixed costs of equipment already installed) could not be covered and bankruptcy was inevitable that production was shut down.

Second, the oil market has for some time been an "alternative asset" for financial speculators. With opportunities in other markets not too bright either they may have delayed accepting losses to move out of oil stock and futures, delaying the price adjustment. According to the Wall Street Journal: "The total number of long and short positions in Brent crude, or **bets on rising or falling prices**, has risen to a record high" in 2016. Speculators were in fact playing a part in a volatile market and influencing prices.

Given the delayed price adjustment on account of these factors, expectations were that having lost out on the huge revenues it derived from oil, Saudi Arabia was bound to drop its adamant stance, cut production and work out a deal for parallel cuts by others in order to reverse the price decline. It chose not to, borrowing hugely instead to finance its budget deficit resulting from the fall in oil revenues and launching on a restructuring strategy that it claims will reduce the country's dependence on oil revenues.

Meanwhile, low prices had begun to pinch US producers and not just non-US oil exporters. Initially US producers shelved planned projects. Investment in oil capacity fell elsewhere as well. According to one estimate, investment in 2015 fell by $126 billion and the fall is continuing this year as well. This was followed by cuts in production from already created capacities. The US Energy Information Agency (EIA) predicts that US production will fall by 830,000 barrels per day (bpd) in 2016 (to 8.6 million bpd), and by a further 410,000 bpd in 2017 (to 8.19 million bpd). Other observers expect the fall to be steeper, buttressing the revival in prices. Speculators are also likely to sense an opportunity and act in way that strengthens price increases. The result is the reversal of the price decline and increase in oil prices to $50 plus a barrel, which is convincing Saudi Arabia that its bet is paying off. It believes that US producers are being squeezed out, ensuring a return to reasonable oil price levels without a loss in its own market share.

Seen in this background, the lack of a production cutting agreement in Vienna was not a failure for the OPEC but a success. Many exporters from Venezuela to Nigeria are suffering economic distress because of low prices and would like a forced adjustment engineered through a supply reduction. But Saudi Arabia was clearly able to sell its argument that the market adjustment it was working towards by not cutting supply, in which US production was held back and reasonable prices restored, was being realized. There seemed to be little resentment among members on the outcome (or lack of it, according to some) of the Vienna meet.

The real question is how the scenario would unfold as prices rise. If it results in a quick return of shale producers to business, then the restoration of prices that are reasonable from the point of view of OPEC is unlikely. Some observers claim that $55-a-barrel would be enough for shale to become cost-effective again. That makes revival of shale production inevitable. But it is known that the costs of extraction of shale oil and gas vary widely across fields, and much higher prices are required to keep most of those fields active. If that is the case, oil prices are bound to rise, speculators would return, and, even if prices do not touch levels they had reached before the global financial crisis, they would rule much higher than the levels they were at early this year.

* This article was originally published in the Frontline, Print edition: July 8, 2016.