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Get Ready for $10 Oil

Global demand remains weak, output is growing and OPECs power is eroding, columnist Gary Shilling warns.

By **A. Gary Shilling** | February 17, 2015

At about $50 a barrel, crude oil prices are down by more than half from their June 2014 peak of $107. They may fall more, perhaps even as low as $10 to $20. Here's why.

U.S. economic growth has averaged 2.3 percent a year since the recovery started in mid-2009. That's about half the rate you might expect in a rebound from the deepest recession since the 1930s. Meanwhile, growth (http://www.imf.org/external/pubs/ft/survey/so/2015/NEW012015A.htm) in China is slowing, is minimal in the euro zone and is negative in Japan. Throw in the large increase in U.S. vehicle gas mileage and other conservation measures and it's clear why global oil demand is weak and might even decline.

At the same time, output is climbing, thanks in large part to increased U.S. production from hydraulic fracking and horizontal drilling. U.S. output rose by 15 percent in the 12 months through November from a year earlier, based on the latest data, while imports declined 4 percent.

Something else figures in the mix: The eroding power (http://finance.yahoo.com/news/why-opecs-losing-ability-set-212224776.html) of the OPEC cartel. Like all cartels, the Organization of Petroleum Exporting Countries is designed to ensure stable and above-market crude prices. But those high prices encourage cheating, as cartel members exceed their quotas. For the cartel to function, its leader—in this case, Saudi Arabia—must accommodate the cheaters by cutting its own output to keep prices from falling. But the Saudis have seen their past cutbacks result in market-share losses.

So the Saudis, backed by other Persian Gulf oil producers with sizable financial resources—Kuwait, Qatar and the United Arab Emirates—embarked on a game of chicken with the cheaters. On Nov. 27, OPECsaid (http://www.opec.org/opec_web/en/press_room/2938.htm) that it wouldn't cut output, sending oil prices off a cliff. The Saudis figure they can withstand low prices for longer than their financially weaker competitors, who will have to cut production first as pumping becomes uneconomical.

What is the price at which major producers chicken out and slash output? Whatever that price is, it is much lower than the $125 a barrel Venezuela needs to support its mismanaged economy. The same goes for Ecuador, Algeria, Nigeria, Iraq, Iran (http://peak-oil.org/news/2014/12/economist-iran-needs-oil-at-125-per-barrel/) and Angola.

Saudi Arabia requires a price of more than $90 to fund its budget. But it has $726 billion in foreign currency reserves and is betting it can survive for two years with prices of less than $40 a barrel.

Furthermore, the price when producers chicken out isn't necessarily the average cost of production,

which for 80 percent of new U.S. shale oil production this year will be $50 to $69 a barrel, according to Daniel Yergin of energy consultant IHS Cambridge Energy Research Associates. Instead, the chicken-out point is the marginal cost of production, or the additional costs after the wells are drilled and the pipes are laid. Another way to think of it: It's the price at which cash flow for an additional barrel falls to zero.

Last month, Wood Mackenzie, an energy research organization, found (http://www.woodmac.com/public/home) that of 2,222 oil fields surveyed worldwide, only 1.6 percent would have negative cash flow at $40 a barrel. That suggests there won't be a lot of chickening out at $40. Keep in mind that the marginal cost for efficient U.S. shale-oil producers is about $10 to $20 a barrel in the Permian Basin in Texas and about the same for oil produced in the Persian Gulf.

Also consider the conundrum financially troubled countries such as Russia and Venezuela find themselves in: They desperately need the revenue from oil exports to service foreign debts and fund imports. Yet, the lower the price, the more oil they need to produce and export to earn the same number of dollars, the currency used (http://www.quora.com/Why-is-oil-priced-traded-in-U-S-dollars) to price and trade oil.

With new discoveries, stability in parts of the Middle East and increasing drilling efficiency, global oil output will no doubt rise in the next several years, adding to pressure on prices. U.S. crude oil production is forecast to rise by 300,000 barrels a day during the next year from 9.1 million now. Sure, the drilling rig count (http://www.bloomberg.com/news/articles/2015-01-30/u-s-oil-rig-count-declines-for-eighth-consecutive-week) is falling, but it's the inefficient rigs that are being idled, not the horizontal rigs that are the backbone of the fracking industry. Consider also Iraq's recent deal with the Kurds, meaning that another 550,000 barrels a day will enter the market.

While supply climbs, demand is weakening. OPEC forecasts demand for its oil at a 14-year low of 28.2 million barrels a day in 2017, 600,000 less than its forecast a year ago and down from current output of 30.7 million. It also cut its 2015 demand forecast to a 12-year low of 29.12 million barrels.

Meanwhile, the International Energy Agency reduced its 2015 global demand forecast for the fourth time in 12 months by 230,000 barrels a day to 93.3 million and sees supply exceeding demand this year by 400,000 barrels a day.

Although the 40 percent decline in U.S. gasoline prices since April 2014 has led consumers to buy more gas-guzzling SUVs and pick-up trucks (http://www.ibtimes.com/gas-prices-fall-so-does-fuel-economy-consumers-flock-trucks-when-they-see-low-prices-1775096), consumers during the past few years have bought the most efficient blend of cars and trucks ever. At the same time, slowing growth in China and the shift away from energy-intensive manufactured exports and infrastructure to consumer services is depressing oil demand. China accounted for two-thirds of the growth in demand for oil in the past decade.

So look for more big declines in crude oil and related energy prices. My next column will cover the winners and losers from low oil prices.

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