Opinions

Why the world missed the oil price crash

By Michael Levi
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Michael Levi, a senior fellow and the director of the Center for Geoeconomic Studies at the Council on Foreign Relations, is the author of "The Power Surge: Energy, Opportunity, and the Battle for America's Future."

On Feb. 1, 2011, oil prices rose above $100 a barrel. For the next three years, they largely stayed there, with few of the dramatic ups and downs that oil markets are famous for. So when prices began falling slowly in June of this year, most industry experts shrugged. Hundred-dollar oil was here to stay, right?

That attitude has made the vicious plunge in oil prices over the past few months all the more shocking. U.S. oil production has been rising for several years; more recently, Libyan oil output has surged, too. Those increases collided with a weak global economy this summer to create a glut of oil. Late last month, members of the Organization of the Petroleum Exporting Countries (OPEC) announced that they would not cut their own production to compensate and stabilize prices. Oil promptly fell below $70 a barrel, down 40 percent from its June peak.

"Oil Enters New Era," announced Bloomberg News. OPEC is "throwing in the towel," declared the head of oil research for a major bank, transforming energy markets "for many years to come." A new age of low-price oil, with OPEC on the sidelines, is upon us, experts declared — and everyone has to adapt.

But before everyone pivots from one dogmatic view of oil markets to a radically different and equally certain vision, we ought to ask: Why were so many people wrong about oil prices? Bad assumptions about how the U.S. oil industry works, and about the power of OPEC and Saudi Arabia, drove our misconceptions about where prices were heading — and continue to confuse us about where they'll go next.

The U.S. boom has been driven by "tight oil" — what many people call shale oil — which is produced by fracking and is more responsive to market conditions than oil developed through traditional drilling. With tight oil, wells can be planned and drilled in a matter of months rather than years, meaning that production can be boosted relatively quickly when desired; conversely, when drilling stops, production drops off quickly. These features led many to conclude that if an oil glut developed and prices began to fall, tight oil production growth would slow rapidly, stabilizing prices.

In reality, even though tight oil is more responsive to markets, the adjustments aren't instantaneous. This was made clear in 2011 and 2012, when booming shale gas production — like tight oil, driven by fracking — drove natural gas prices down nearly 60 percent in one year before producers pulled back. The point was reinforced last winter when, faced with unusually cold weather and spiking demand for fuel, the industry couldn't ramp up production quickly, and benchmark natural gas prices briefly doubled in a month. Had people taken these events to heart, they would have been more open to the possibility of a dramatic change in the price of crude.

An even more critical reason people missed the oil crash was a failure to think seriously about how politics shapes oil production, particularly in the Middle East. Two mistaken assumptions have long convinced people that prices couldn't fall too far.

The first is that OPEC is a well-functioning cartel that keeps oil prices near an agreed target. Faced with a modest surplus of oil in the global market, a coherent cartel would have pared back its production, propping up prices and revenue.

Except OPEC has long been miserable at coordinating; it's a collection of countries with little in common aside from oil. Qatar doesn't care about Venezuela's future. Saudi Arabia would rather see Iran fail than succeed. It's all too tempting for each member to encourage the others to cut production while doing nothing themselves: They thus might reap greater benefits from higher oil prices. The problem — common to all cartels — is that when every member has this attitude, no one cuts production, and the cartel crumbles.

The lack of OPEC cohesion we've seen recently isn't the exception — it's the norm. When oil prices last crashed, in 2008, OPEC was slow to respond. The group didn't announce a real production cut until prices had fallen from $145 to $60, and only when they dropped below $40 did the group take decisive action. Similarly, in the mid-1980s OPEC did not cooperate in the face of painfully low prices; only when Saudi Arabia punished the group by flooding the market did it achieve a modicum of coordination. Indeed, to the extent that OPEC has succeeded previously in quickly pulling oil off the market, it has been in the face of intense pressure, either from ultra-low prices or, in the 1973 oil crisis, unusual geopolitics.

Even for those who doubted OPEC as a whole, there was always the second assumption: that the Saudis would step in alone. Saudi Arabia, which controls roughly a third of OPEC production, has long been more active than the group's other members in attempting to influence markets. And in recent years, many analysts concluded that Saudi Arabia had decided that $100 a barrel was the right price for oil. This belief was reinforced by the Arab Spring, which spurred massive Saudi spending to buy domestic peace, convincing many that relatively high prices would remain essential to the Saudi bottom line. Such was the perceived power of the Saudis that observers also imagined Riyadh would prevent prices from rising much higher, lest consumers start abandoning oil.

History cautions greater skepticism. Just 15 years ago, most oil analysts predicted that crude would stabilize around $20 a barrel for the foreseeable future, arguing that this was the magic price the Saudis — and OPEC

— would target. The 2000s proved that spectacularly wrong: Oil prices rose nearly 15-fold in less than 10 years while Saudi Arabia did little to respond. And Saudi Arabia does not need to balance its budget every year; it has money in the bank and has often run deficits in the past.

Yet despite confidently discounting the possibility of a price crash mere months ago, analysts are already explaining with great confidence what the new oil world will look like. They herald an age in which U.S. oil dominates world markets — one reporter went so far as to nominate the shale revolution as Time magazine's Person of the Year — and predict low prices for years to come.

More circumspection is in order. The past decade has taught us that oil prices are rarely stable for long and that political conditions, not just economic fundamentals, are critical to their evolution. Indeed, some analysts who paid attention to geopolitical factors warned of a price drop at least a year ago, when a range of forecasters projected far more supply than demand. I was typical of those, warning of a looming price crash for nearly two years — but was never able to nail down the timing.

What happens to prices now? A relatively rapid rebound could be driven by a mix of factors: a fall-off in the growth of U.S. oil supplies as companies reassess their bottom lines, a stronger-than-expected global economy or an eventual decision by the Saudis to cut back. But prices could fall even further, too, if the American industry confronts low prices by becoming more efficient, if the global economy continues to falter or if Saudi Arabia remains on the sidelines. Or, less likely, prices could even stabilize where they are now. Each path has far-reaching and distinct economic and political consequences.

And only the reckless would bet with any confidence on one particular outcome.

mlevi@cfr.org

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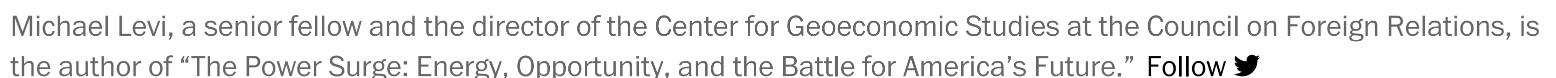

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