Oil Market Report – November 2014

So now we know! OPEC members got together last week against a back-drop of startling falls in the oil price but still decided to maintain current production levels, with a further meeting planned in 3 months' time. This to "re-assess the market and make an appropriate decision at that time". On hearing the news, the market reacted swiftly and prices dropped by a staggering $4 per barrel in 2 hours (over 2.5 pence per litre) on 27th November. The logic is simple; with the world now awash with crude oil, only OPEC members have the power to immediately cut supply and put a floor on oil prices. And when they didn't, prices crashed.

OPEC meetings have few outside observers (after all it is a cartel) so we can only imagine the discussions that go on behind closed doors. But it seems a fair bet to assume that over the last few years, OPEC meetings have been rather relaxed affairs. What with soaring oil prices and never-ending demand growth, OPEC Ministers could no doubt take it easy; chat a bit about maximising production and bulging bank balances, before heading off for a few hours sight-seeing in the Austrian capital (OPEC meetings traditionally take place in Vienna). But one suspects that this year's meeting was a far more fraught affair. Faced with a situation where oil prices have dropped from $112 per barrel to $75 in the space of 3 short months, many OPEC members are now looking down the barrel of a gun called "economic meltdown".

That bad? Well yes actually. Have a look at the graph attached and see the kind of oil prices that OPEC members require to balance their national budgets. At the top of the pile (or bottom perhaps) is Libya, who require an oil price in excess of $180 a barrel to ensure that the country does not go into the red – not surprising really when you consider that oil and gas make up over 90% of their national income. But Libya is not alone as the graph amply illustrates. Even the mighty Saudi Arabia are now looking at prices that can no longer keep up with their giant infrastructure projects, most of them hastily embarked upon in the aftermath of the Arab Spring.

And that sums up the problems that OPEC face. They are a disparate bunch (exuberant Nigeria has little in common with austere Saudi Arabia, who in turn have little economic alignment with the socialist state of Venezuela), but they do have one thing in common and that is that they desperately need oil money to keep their people happy. Since the Arab Spring, this has been a particularly acute issue for the Middle Eastern members of OPEC, who have used oil money to invest in social and economic programmes (hospitals, schools, roads, power plants etc) in an attempt to hoodwink the population that all is well and that democratic reform is a waste of time.

So in that light, why did the Turkeys vote for Christmas? Well firstly, cutting oil production obviously means that revenues head southwards before improving. And the latter only happens if the drop in production stimulates an oil price rally. If not, OPEC members saddle themselves with a double whammy of lower production and a sluggish oil price. This is the main reason why OPEC members are (in)famous for declaring to the world that production is going to be reduced (in the hope that oil prices will surge) only to pump more oil than ever and thus enjoy maximum revenue (from high production and even higher prices). But more significantly, it seems that OPEC is hoping the market will do their dirty work and that lower prices will naturally remove the current glut of supply. See it as a grand game of poker where on the table we have the 2m barrels of daily oil production that needs to be removed from the market to halt the drop in prices. It's the wee small hours and we have entered the final plays of the game with only 2 participants left holding sufficient stakes to continue; OPEC and North America. OPEC have played their hand (a bluff?), so all eyes turn to North America, where the shale oil producers now find themselves in very unfamiliar (and uncomfortable) territory.

Forget the tar sand producers – they started being uneconomic when prices dropped below $85 per barrel and production there has duly dropped off. But at $75 (and remember that $75 for Brent means less than $70 for American crudes), the shale oil miracle starts to go sour. Marginal shale oil production started to be reined in when prices dropped below $80, but below $70 and you can expect well capping, project cancellations and possible financial bankruptcies – the latter being particularly likely amongst those producers who have borrowed heavily to

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fund production (see our last report). OPEC is banking on all of these outcomes (not to mention the tightening of oil supply from more conventional non-OPEC oil plays) and if the plan works, then it's happy days – OPEC production levels will have been maintained whilst the oil price steadily recovers. If not then the decision to meet in 3 months becomes more relevant as it will be at that point – and having lost the game of poker – that the cartel will announce official production cuts and a throttling back of world oil supply.

But what a dangerous game for OPEC to play! To this observer it seems inevitable that the market will take much longer than 3 months to naturally balance and this means that prices will either keep dropping or will stay put. Not good news for the already crumbling economies of Venezuela, Libya and Iran, but pretty good news for consumers who will enjoy the benefits of cheaper travel and lower priced goods. Which is all very jolly as the festive season approaches, and we recommend you enjoy the good times whilst they last. Oil prices and OPEC have a horrible habit of biting back and come the spring, rises in the oil price would seem inevitable. This game of poker is a long way from being over...

* Plus don't forget the bitter religious divisions when Sunni Saudi Arabia sits down at the negotiating table with Shia Iran.