Excess supply meets static demand

Investors face rude awakening as Saudi oil power challenged

by Nick Butler

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This is the first of two articles on the oil price fall. The second, on the political implications around the world, appears tomorrow.

The 25% oil price fall in less than three months is exceptional. In a politically driven market, many people believe a political decision by someone, somewhere must have forced prices down. The most popular conspiracy theory is that the US and Saudi Arabia have combined to take money away from their major enemies – Russia and Iran – and bring them to the negotiating table to sort out a deal, respectively, on Ukraine and Iran's nuclear ambitions.

This notion has some plausibility – but I don't believe it. The reality is more prosaic. As I have been saying for well over a year, excess supply continues to chase static demand. The result is falling prices. And this may well continue.

The interesting question is what happens next. That's down to the Saudis. The risk for the whole industry, and for many countries dependent on oil revenues, is that Saudi Arabia may have lost control of the market. Prices could go a good deal lower with wide and mostly negative consequences, starting with more regional instability and a cutback in investment which can only feed the next cycle. We tend to have a mental image of Saudi Arabia from the 1970s and 1980s: a fabulously wealthy country with a tiny population sitting on a sea of oil, staffed by brilliant technocrats who can set the world price by adjusting output and exports at will. This power supposedly gives Saudi Arabia not just enormous revenues but also US protection in a dangerous world.

If it ever reflected the truth, this image is now wrong in almost every respect. Saudi rulers are struggling in the face of dissent across the Middle East. The population is now almost 30 million, up from 5.7 million in 1970. The technocrats have failed to develop an industrial economy or to find gas to provide local power. Domestic oil demand keeps on rising. 30 million Saudis now use as much oil (3m barrels per day) as 203 million Brazilians. The Saudis may no longer be in any position to reverse the price fall. The danger of the trend since June is that, with each step downwards, other producers tend to increase short-term production to maximise much-needed revenue. Any field which can produce a bit more is pushed a little harder; normal maintenance schedules are postponed, and so on. The price drop over the last three months has not generated any fall in production.

On the basis of standard economic theory, a fall in prices should stimulate demand. But the oil market is a special place where production costs are much disguised by consumer taxes or subsidies. We are not likely to see a dramatic demand effect as a result of what has happened — not least because in the US, Europe and Japan, oil demand is in structural decline.

The only action which would break this trend is a sharp and sustained Saudi output cut. Saudi Arabia has acted in this way in the past but never alone. Its cuts have always been part of a strategy agreed (even in only a modest way) with the rest of the Organization of the Petroleum Exporting Countries. But the world has changed. It's hard to think of any OPEC state, except perhaps Kuwait, in a position to accept a sustained cut in production and revenue.

The Saudis are on their own. Restoring order would require a serious cut in output of perhaps 2m bpd for a sustained period to rebalance a market in surplus even in the absence of significant supplies from Libya and Iran. In the short term such action would require a rewritten budget, reduced domestic welfare and defence spending, and a cut in subsidies to regional allies struggling in the aftermath of the Arab Spring.

In this febrile setting, the scope for miscalculation is enormous. Oil prices have been set by politics but fundamentals have a habit of reasserting themselves. Once started, a price fall will be very hard to reverse. Much of the Saudis' oil market power is psychological. People believe that, because they have controlled prices in the past, they will do so for ever. Many investments across the world are grounded on that belief. If it turns out not to be true, investors face an uncomfortable awakening.

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