My initial oil market review revisited. By Tariq Shafiq *

The conclusion of my last Iraq oil market review was reflected by its heading that, '*Politics cannot be ruled out, but market fundamentals remain in force.'* However, no doubt, views on the subject do differ and each is worthy of consideration**.** *My aim here is not to dispute but to reflect further on this important issue.*

An article was published on the subject, prior to mine, by the Iraqi Economic Network, IEN, which concluded that the USA is the sole deciding player, fixing the crude oil price of the global market leaving no part for market fundamentals.

A second article published in the IEA after mine, written by way of commentary, recognized the role of market fundamentals but concluded that the politics at play is the culprit, and therefore only **political decisions** can end the current oversupply of oil through profound deliberation.

The author of the above commentary suggests that Saudi Arabia, as OPEC leader, had an agreement with Russia to jointly reduce oil production by 10% of their 42mbpd in order to relieve the market from its "present over-supply of 4+ mbpd,[million barrels per day]" and to return to a price level of $70-80. However, that Saudi Arabia reneged on the agreement out of political and strategic objectives, which were shared with or under the influence of the USA. Instead Saudi Arabia increased its production in order to harm Russia, Iran and Iraq.

The author adds that the presence of Shale oil has the advantage of raising the market benchmark price to a level commensurate with its higher cost. And, concludes that the intention of Saudi Arabia to drive shale oil out of the market will lead, in perpetuity, to periods of low oil price for the life of our reserves. Had Saudi Arabia cooperated it would have had the effect of becoming the "magic whip on prices," and demonstrated that only ***political decisions***, not market fundamentals, can end this oversupply.

Being no 'market expert', I referred back to what market experts have to say and came up with these conclusions.

Let me start with what a few experts have to say:
Mr. Jason Bordoff, a former energy adviser in the Obama administration, now Director of the Center on Global Energy Policy at Columbia University reflects, "I can imagine a set of circumstances that could develop this year, *including a fall in US output,* where the economic pain would force countries to act to

stabilize the price." He and other analysts believe that from a Saudi perspective this is not an opportune time to consider cuts. *For not only is Iran's re-entry into the global market expected to increase supplies, but Iraq has also been increasing production rapidly.*

Still, although the Saudis are burning through their financial reserves, there is no danger of depleting them soon. Because of this, Mr. Bhushan Bahree, an OPEC analyst at the energy consulting firm, IHS Energy in Washington, expect the Saudis to stay the course. He asks, "*If Saudi Arabia cuts production on its own, what is next? Iran produces more, Iraq produces more. So what have they done? Pushed the price up temporarily but lost market share, which they may have difficulty recovering".*

The facts

There is fierce competition on the global stage among the major producers, USA, Russia, Saudi Arabia, Iraq and Nigeria, who are engaged in a battle to maintain market share, with others such as Iran and Mexico expected to join.

The over-supply was mainly generated and maintained by the US shale oil producers over the current half decade at incremental additions of some 1mbpd, with the expectation that OPEC and, namely Saudi, shrink their share and *maintain OPEC's role as the residual producers.*

The global production last year amounted to 96.3 mbpd, of which 94.5 mbpd was consumed, leaving a *surplus of 1.8mbpd,* which was stored.

It seems that, an agreement between Saudia and Russia neither in principle nor in line with the above details materialized (reference to the above commentary: joint act to reduce 10% of their combined production and relieve the market from its 4+mbpd surplus, so did the above commentator said), although the current surplus is less than half as much!

I am afraid that commercial reality does not accommodate for such acts of self-sacrifice where country interests dominate over that of others. OPEC and Russia appear to have left it up to market fundamentals. Whilst Saudi and its OPEC associates likewise have declared a de facto policy to preserve their market share, which in fact is working, but not without great harm, pain and sacrifice of many as well as themselves.

*The IEA, as witness***,** reported that *Saudi Arabia's lead of OPEC strategy* to take back market share from rival non-OPEC producers is finally *showing signs of working*. Non-OPEC supply held at 58.5 mbpd in November 2015, but annual growth slowed to below 300 kbpd from 2.2 mbpd at the start of 2015.

OPEC crude output edged 50 kbpd higher to 31.73 mbpd in November, with record production by Iraq and higher supply by Kuwait.

Reality Check confirms that: there is evidence that the Saudi-led strategy is starting to work. Lower prices are clearly taking a toll on non-OPEC supply, with annual growth shrinking below 0.3 mbpd in last November from 2.2 mpbd at the start of the year. A 0.6 mbpd decline is expected in 2016, as US light oil (the driver of non-OPEC growth) starts decreasing. As companies make further spending cuts in reaction to sub-$50 per barrel of oil, the impact on supplies - both from non-OPEC and OPEC - will be even more pronounced in the longer term.

The real issues:

US policymakers have been concerned about the country's dependence on imported crude oil over many decades. Those concerns were substantiated in the 1970s when rising oil prices led to recession and economic stagnation. Since then, many US Presidents promised to end the country's dependence on imported petroleum. Success has finally been achieved in the form of recent US shale oil and natural gas production.

The shale revolution, so described by the experts, was the product of advances in oil and natural gas production technology in a new combination of horizontal drilling and hydraulic fracturing. These technological advances required initially high oil and gas prices. Lately, US shale oil producers must have *succeeded in advancing sufficient technological and managerial efficiency to survive in the face of drastically low prices*, to the extent that by the middle of 2015 shale firms had managed to limit reduction to only some 400 kbpd from output.

However, according to the IEA, the USA increased its oil production more than any other country in the year as a whole, producing an additional 900 Kbpd. In 2014, tight oil production drove US oil output higher by 1.5mbpd – the largest single-year rise in US history. Over the years 2014 down to 2011, the US produced 11.644mbpd (2014), 10.069mbpd (2013), 8.904mbpd (2012) and 7.861mbpd (2011) respectively. *By 2030, according to projection of the BP statistics, the US is likely to become self-sufficient in oil, after having imported 60% of its total demand as recently as 2005.*

On 19th January, the IEA issued a stark warning that, *"the oil market could drown in oversupply."* Addressing the fact that shale oil has resulted in an added 4.2mbpd over the past five years of total global supply. Although only 5% of global production, it has had a significant impact on the market by raising the prospects of recovering vast amounts of resources formerly considered too hard to extract.

Experts from among oil producers fear seriousness consequences, *yet for the most part warnings such as those of the IEA have gone unheeded.*

This situation drove Saudi Arabia in November 2014, to table a motion in OPEC to produce as usual in order to protect their share of the market, in the hope of driving higher-cost shale oil producers in America and elsewhere out of the export market.

Should OPEC or Saudia be blamed?

OPEC's motion, or Saudi's abandoning of its traditional role as residual producer, marks a prodigious change in OPEC policy. Since its inception over 5.5 decades ago, OPEC has been concerned with market stability and preservation. As a residual producer for many years, OPEC's total production has been limited to around 30 mbpd, leaving the lion's share of around 60mbd to non-OPEC producers to produce to full capacity. That is to say that the OPEC countries, whose reserves amount to some 2/3 of the world's total oil reserves, are limited to producing around 1/3 of global oil demand, while the non-OPEC producers, whose reserves amount to around1/3 of the world's, conversely enjoy the benefits of meeting 2/3 of the world's oil demand, whilst their oil production is only governed by the natural decline off peak plateau!

It is important to mention at this juncture that the decline has already commenced opening a market venue for Middle East, ME, producers of the low cost and rich reserves to fill the gap. However, shale oil appears to have taken over for the short, medium or long term; I wonder if any one knows.

However, the preservation and/or expanding market share issue will get much harder and costlier to achieve as the ME producers further monetise their reserves, unless OPEC succeeds in abandoning its residual producer role.

By the end of the Concession Era after the mid-1970s, the ME national oil companies (NOCs) successfully managed the exploration, production and development of their oil and gas resources. Going by the example of Iraq, Iraq's national oil company, INOC, built up the country's production rate from 1.25 million barrels per day (mbpd) to above 3.5+ mbpd within a few years and added reserves at the rate of 6+Billion barrels a year, which was equivalent to the rest of the world's added reserves. However, Iraq's production rate, like the rest of the major ME producers, never managed to do justice to the wealth of its reserves. The annual major ME producers' depletion rate remained around 1%, while that of Iraq's was only a fraction of this regional average, in contrast to the world's average of 4-5% rate. This low depletion rate was inherited from the practice of concessionaires, the Major International Oil Companies (IOCs), which rationed their production amongst

their ME concessions in a manner that best suited their shareholders' interests.

Apart from Saudia, the production rates of Iraq after 2010, Iran from the end of 2015, and Kuwait, all OPEC members and major oil producers, have remained below 1% depletion, far below the 4-5% and higher rates applicable elsewhere. How would they be able to increase their production rates and meet their growing economic needs without OPEC growing out of its residual producer role, limited to 1/3 of the world's oil demand?

This is the crux of the existing problem, which concerns not just Saudi, but all the OPEC members and especially Iraq, Iran and Kuwait, to mention a few. US's production rates during the years 2011 to 2014 amounted to 7.9 mbpd (2011), 8.9 mbpd (2012), 10.1 mbpd (2013) and 11.6 mbpd (2014) respectively.

OPEC is faced with the problem of its members' needs to further monetise their reserves at a time when US shale oil is increasing at a rate 1 mbpd.

Is there any justification for the non-OPEC producers to single out Saudi and/or OPEC to cut production to make room for US shale oil, without the larger producers, US and Russia joining in reducing theirs?

Bearing in mind that the US is the biggest producer today, followed by Russia, despite their combined proven conventional oil reserves (US and Russia at 48.5 and 103 Billion barrels respectively) forming a fraction of the combined reserves of Iraq's (150B), Iran's (158B) or Kuwait's (101.5B), not to mention Saudi Arabia's (268B).

Concluding remarks:

Unfortunately, the entry of shale oil has enforced the rules of market fundamentals with US power politics behind it. Saudia and the other OPEC producers realise that their efforts, as painful as they are, cannot and did not aim to drive out the total shale oil from the market (as the above second commentary feared). Saudia and OPEC aimed at preserving theirs share of the market.

Certainly a political decision would have been desirable had the surplus been shared fairly by the major producers from among OPEC and non-OPEC members. But I am afraid such fair sharing is not attainable voluntarily in the real business world.

Unfortunately, if we have really entered a new chapter in the history of the oil market starting to work like any market for goods not subject to a degree of oligopoly, unified OPEC and renewed understanding between the producers

and consumers, this signals unstable market, strenuous and painful struggle and a very long wait for the return of past three digit crude oil prices.

The US is on a fast road to divorcing from its ME satellites and mutually advantageous political accommodation will become harder to attain.

I wonder if this is the price of ME sovereignty, autonomy and oil nationalization, which otherwise appears to require a bargain to be made with the devil as it were.

It is time that we Iraqis the other opinion, unite, move out of the practices of a failed ethno-sectarian corrupt state, realise where our national interests lie and act accordingly. It is time we stop battling foes instead of making friends.

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