Implications of Sustained Low Oil Prices

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COUNTRIES AND COMPANIES OF ALL SIZES CONTINUE TO ADJUST TO THE NEW ECONOMIC AND MARKET REALITIES FOLLOWING THE OIL PRICE COLLAPSE OF 2014. And while the growth in U.S. unconventional production appears to be slowly abating, the upsurge in Organization of the Petroleum Exporting Countries (OPEC) output, robust global stock levels, and ongoing uncertainty around the strength of demand suggest that the oversupply and surpluses are likely to continue well into next year, exerting continued downward pressure on prices.

For nations that derive significant government revenue and economic support from oil export sales, the downturn has been painful (prices are some 50–60 percent lower than the summer of 2014). For consumers, the price relief has been a Godsend, though to date those energy savings have yet to translate into robust spending and economic growth elsewhere. For nations that both produce and consume large volumes of oil, a significant (and sustained) price drop necessarily presents a bit of a mixed bag, carrying both positive and negative implications. And while some of these impacts are evident immediately, others take a bit longer to manifest themselves.

In the United States, the largest source of incremental global oil supply growth in the last several years, after months of lower prices and reduced rig counts, the resiliency of production growth is finally beginning to roll over and show signs of stress. After reaching some 9.6 million barrels per day (mmbd) this summer—the highest oil production level experienced in 40 years—the U.S. Energy Information Administration (EIA) now forecasts 2015 output levels at 9.2 mmbd with a further decline (to 8.8 mmbd) projected for 2016.[1]

At issue, however, is the question of how low prices can go, and more importantly, how long they are likely to remain at depressed levels. Both the level and duration of the price trough have severe implications for future investment and output volumes available over the coming years. Loss of skilled workers through cost cutting and deferral or cancellation of mega projects set the stage for future price increases as investment lapses lead to gaps in new supply additions coming to market.

[1] U.S. Energy Information Administration, "Short-Term Energy Outlook (STEO)," September 2015, http://www.eia.gov/forecasts/steo/archives/sep15.pdf

Consumers have clearly benefited from lower energy prices. Average household energy expenditures are expected to fall by some 17 percent in 2015 and lower oil prices are projected to translate into $700–1,000 in energy and fuel cost savings for the average American family this year.[2] But even with gasoline at $2 per gallon, a level not seen since 2004, the economy overall has seen only modest change. Job creation in August was below the monthly average of the first seven months of the year, suggesting that slower growth in some pockets of the global economy are adversely impacting sectors in the United States and elsewhere. Oil and gas sector jobs have been slashed along with energy company budgets. And consumer spending is up only a modest 3.5 percent from a year ago when energy prices were significantly higher.

The prospects for reversal anytime soon are not bright. Absent a major supply disruption or political upheaval (not out of the question given insurgency in Yemen, distress in Nigeria and Venezuela, and continued instability in Iraq, Syria, and Libya) or a resurgent rise in economic growth and oil demand, the last quarter of 2015 and beginning of 2016 look equally bleak for producers. Add to that the dollar strength and the likelihood of incremental new supplies coming online from places like Iran, Iraq, and Libya as well as quick-cycle U.S wells, and you have the makings for a persistent price slump while we work off the current surplus. In the longer run, organizations as diverse as the International Monetary Fund, EIA, and the International Energy Agency plus private banks and investment houses all point to the growth benefits derived from lower energy prices, but projections of economic improvement and demand growth vary widely, a realization always seemingly challenged by other economic "headwinds."[3]

Around the globe, the economic and social impacts of the oil price collapse are stark and uneven. Conventional onshore producers in the oil-rich Middle East, including Saudi Arabia, have some of the lowest lifting costs in the world, yet (with few notable exceptions) budgets are staining as export revenues are curtailed—even if volumes are up. For countries like Iran and Russia, hampered by the combination of sanctions and low oil and gas prices, economic strife is palpable and unrelenting—and may encourage regional and geopolitical or financial alliances that were previously unthinkable.[4] For new producers in East Africa or those already economically or politically challenged (such as Venezuela, Algeria, Libya, Nigeria, Brazil, and Iraq) or in the midst of undertaking reforms (Mexico), lower revenues and less attractive investment prospects are far from good news.

From an environmental and energy security perspective, the impacts of sustained lower oil prices are also necessarily a bit more nuanced. Depending on demand elasticities, lower oil prices should, in theory, stimulate additional oil demand, while at the same time reducing the economic attractiveness of higher-priced but less-polluting energy forms, at least in the transport sector—not a good outcome from an environmental perspective. Additionally, lower gasoline pump prices tend to encourage more driving, the purchases of large and less fuel-efficient cars and trucks, while tamping down the demand for more expensive hybrids, gas-powered, or electric vehicles. And while public policy choices such as mandates, tax incentives, and HOV lane accessibility can be used to partially offset this "economic advantage,"

[2] Adam Sieminski, "Effects of Low Oil Prices," U.S. Energy Information Administration, February 2015, http://www.eia.gov/pressroom/presentations/sieminski_02262015_csis.pdf.

[3] International Monetary Fund, "Global Implications of Lower Oil Prices," July 14, 2015, http://www.imf.org/external/pubs/ft/survey/so/2015/INT071415A.htm; International Energy Agency, "Oil Market Report," https://www.iea.org/oilmarketreport/omrpublic/; U.S. Energy Information Administration, "Short-Term Energy Outlook (STEO)."

[4] Frank Verrastro, Larry Goldstein, and Guy Caruso, "Oil Markets: 'Trouble Ahead, Trouble Behind,'" CSIS, October 10, 2014, http://csis.org/publication/oil-markets-trouble-ahead-trouble-behind.

the opportunity to displace or replace liquid petroleum fuels in transportation is likely to be delayed by lower oil prices.

Sustained low oil prices discourage higher cost development, regardless of source, potentially subordinating security and diversity of supply considerations to one of comparative price savings. At low oil prices, the economics of more expensive liquefied natural gas (LNG) projects also come into question. Security comes in many forms, not the least of which includes having a diverse and robust global market, strategic stocks to draw prompt barrels from in times of significant shortfalls and policies that, at once, support balancing prudent and timely development of indigenous (fossil and renewable) energy resources with environmental stewardship, economic improvement, strong trade ties, and a future-oriented outlook as the energy landscape continues to change.

How low can oil prices go, and more importantly, how long are they likely to remain at depressed levels?

Nations with diversified and strong economies can benefit from price stability, recognizing that the period of 2010–13 may have been the near-term outlier in oil price terms. Those countries highly dependent on oil-export revenues, however, remain seriously challenged. Some, with strong balance sheets and robust treasuries, will survive the price downturn. Others, with fewer options and less flexibility, may not. Widespread instability and failed states are not desirable outcomes for anyone.

As we move toward the end of the year, financial and tax considerations related to inventory draws will undoubtedly influence supply decisions, even while potentially adding to the existing over supply. Oil and gas exploration are by nature capital intensive and often require years of upfront spending in terms of lease acquisition, explorations, appraisal, and development before commercial volumes are produced. Geopolitical disruptions remain a constant threat. The prospects for robust and widespread global recovery remain elusive.

The rise in unconventional oil and gas has expanded the opportunity pool of future supply, added more nations to the mix of prospective producers and already altered global energy flows. But we are still in the very early stages of development and multiple outcomes—not all desirable—have yet to be identified. Supply-demand relationships between nations will inevitably shift, intraregional trade may expand at the expense of longer-haul trade, and geopolitical alliances may be altered as a consequence.

The energy landscape remains in the midst of dynamic change. It will impact and be impacted by a number of resource, economic, governance, trade, foreign policy, security, and environmental policies and events. The dramatic growth in unconventional oil will likely extend the life of fossil fuels, and lower prices (for a time) should benefit consumers everywhere. But as with all depletable resources, underinvestment now is likely to bring unpleasant consequences in the not-too-distant future. □