Vox
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Oil prices keep plummeting as OPEC starts a price war with the US

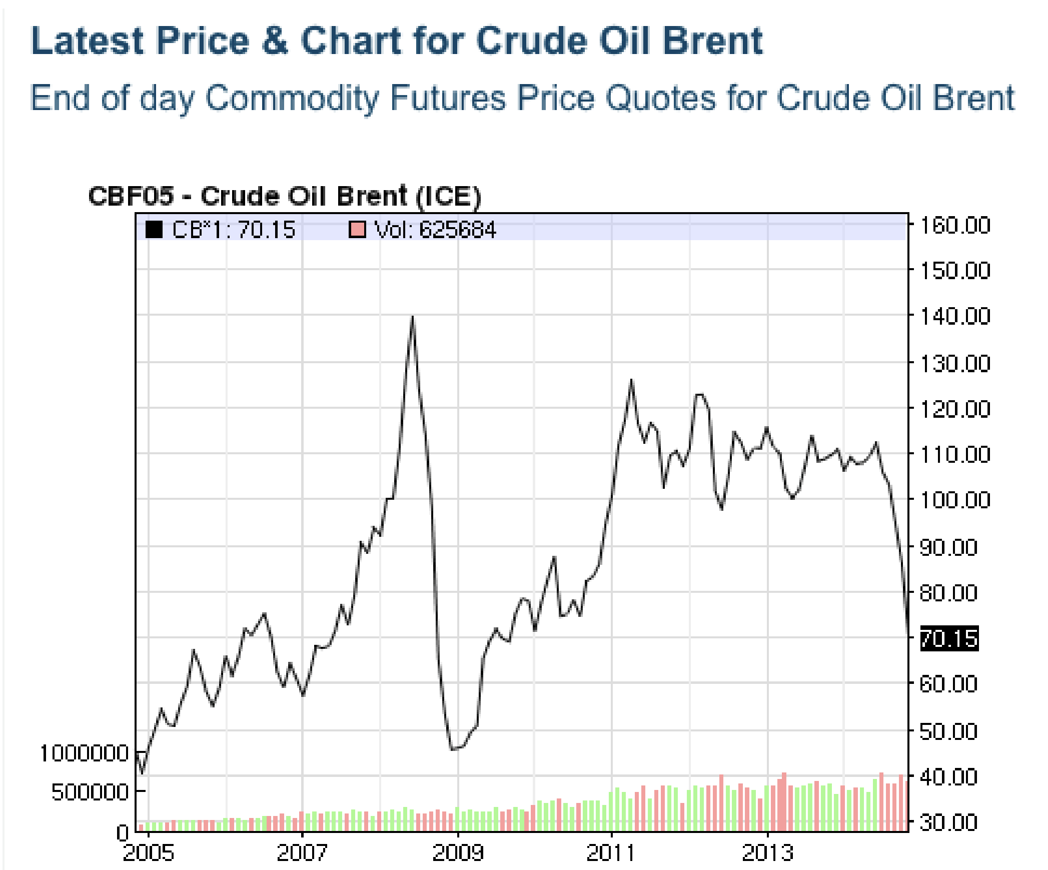
Updated by Brad Plumer on November 28, 2014

Oil prices have been dropping sharply over the past three months — a huge energy story with major repercussions for dozens of countries, from the United States to Russia to Iran.

OPEC is now engaged in a price war with US shale oil producers

But on Friday, prices went into serious free-fall. The reason? OPEC — a cartel of oil producers that includes Saudi Arabia, Iran, Iraq, and Venezuela — had a big meeting in Vienna on November 27. Before the gathering, there was speculation that OPEC countries might cut back on their own oil production in order to prop up prices. But in the end, the cartel couldn't agree on how to respond and did nothing.

Oil prices promptly nosedived, with the price of Brent crude now hovering around $70 per barrel:



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This marks a big shift in global oil politics. Essentially, OPEC is now engaged in a price war with oil producers in the United States. The cartel will let prices keep falling in the hopes that many of the newest drilling projects in the US will prove unprofitable and shut down.

This is a risky stand-off for OPEC, as many of its member countries require high oil prices to balance their budgets. Iran, for one, is facing a real pinch. It's also a sign that OPEC's influence over global oil markets may be waning.

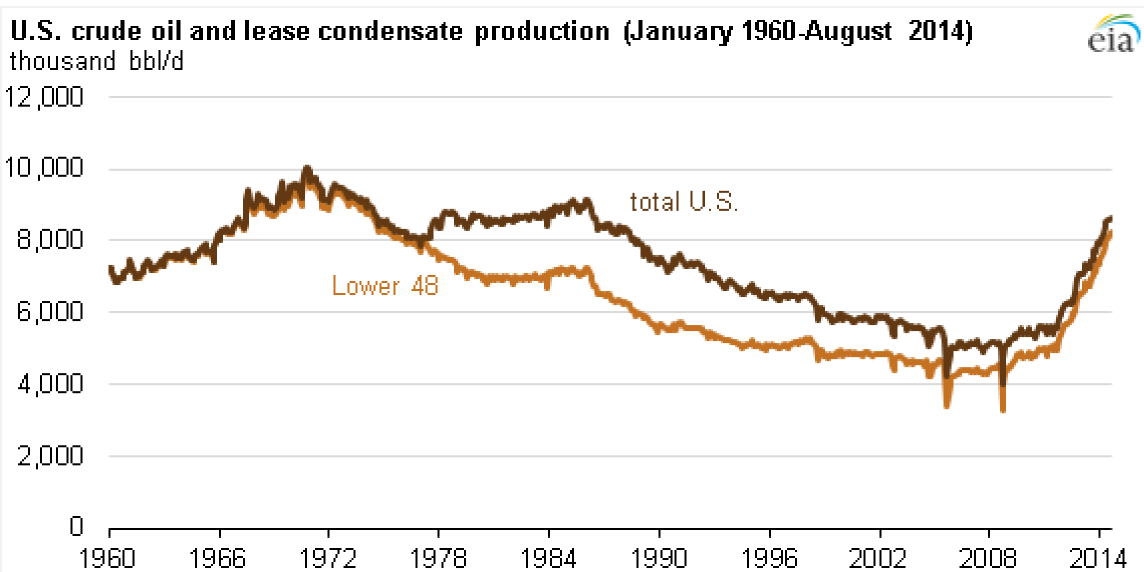
Below is a basic overview of how we got to this point — and what this oil price war means for the rest of the world.

Why oil prices have been plummeting in 2014

To understand this story, we have to go back to the mid-2000s. Oil prices were rising sharply because global demand was surging — especially in China — and there wasn't enough oil production to keep up. That led to large price spikes, and oil hovered around $100 per barrel between 2011 and 2014.

But as oil prices increased, many energy companies suddenly found it profitable to start extracting oil from difficult-to-drill places. In the United States, companies began using techniques like fracking and horizontal drilling to extract oil from shale formations in North Dakota and Texas.

That led to a boom in "tight oil" production, as the US has added about 4 million new barrels of crude oil per day to the global market since 2008. (Global production is about 75 million barrels per day, so this is a significant number.)



(Energy Information Administration)

Up until very recently, however, that US oil boom — along with increases in Canada and Russia — had a fairly minimal effect on global prices. That's because, at the exact same time, geopolitical conflicts were flaring up in key oil regions. There was a civil war in Libya. Iraq was a mess. The US and Europe slapped oil sanctions on Iran and pinched that country's exports. Those conflicts took more than 3 million barrels per day off the market.

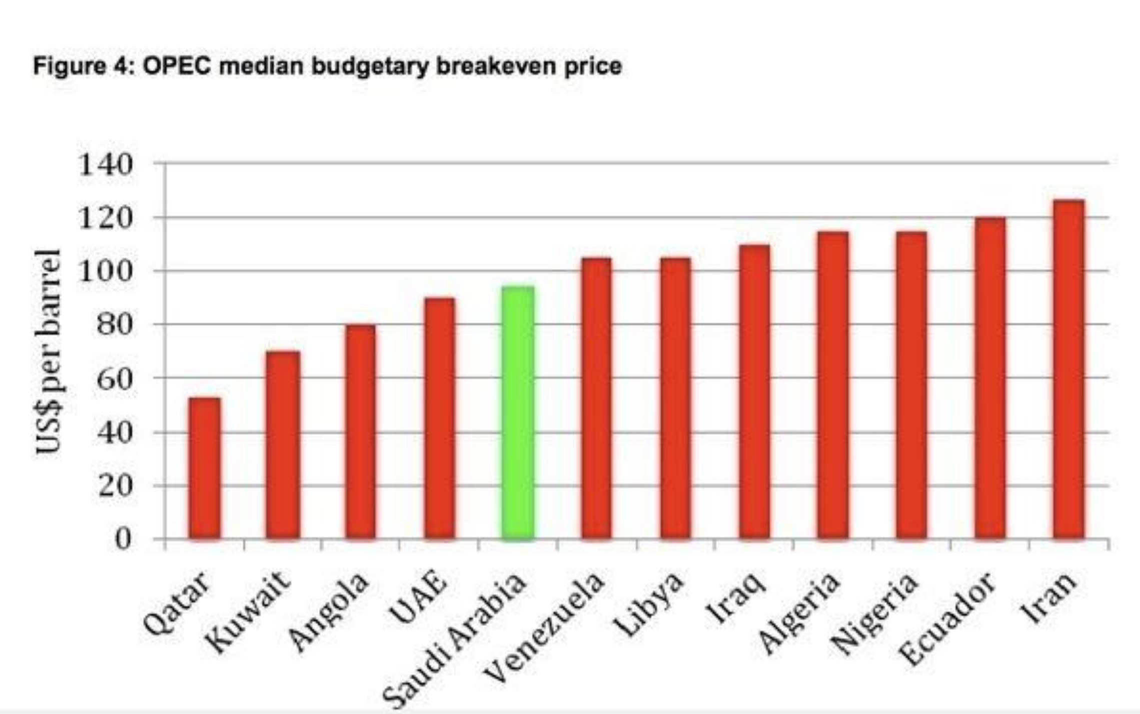
Things changed again around September 2014. Many of those disruptions started easing. Libya's oil industry began pumping out lots of crude again. And even more significantly, oil demand in Asia and Europe has been weakening — particularly in places like China, Japan, and Germany.

The combination of weaker demand and rising supply caused oil prices to start dropping from their June peak of $115 per barrel down to around $80 per barrel by mid-November. Oil is still much pricier than it was a decade ago (when it was still around $40 per barrel). But it's dropping for now.

OPEC's surprising response: Let prices keep falling

That brings us to OPEC, which still produces 40 percent of the world's oil. In the past, this cartel has often tried to influence the price of oil by coordinating either to cut back or boost production.

At its big meeting in Vienna on November 27, there was a lot of heated debate among OPEC members about how best to respond to this current drop in oil prices. Some countries, like Venezuela and Iran, wanted the cartel (mainly Saudi Arabia) to cut back on production in order to prop up the price of oil. The reason is that these countries need high prices in order to "break even" on their budgets and pay for all the government spending they've racked up:



OPEC "break-even" prices in 2012. (Matthew Hulbert/European Energy Review)

On the other side of the debate was Saudi Arabia, the world's largest oil producer, which was opposed to cutting production and willing to let prices keep dropping.

For one, officials in Saudi Arabia remember what happened in the 1980s, when prices fell and the country tried to cut back on production to prop them up. The result was that prices *kept* declining anyway and Saudi Arabia simply lost market share. What's more, the Saudis have signalled that they can live with lower prices around $80 per barrel in the short term. (The government has built up massive foreign-exchange reserves to finance deficits.)

Saudi Arabia was in favor of letting prices continue to fall

In the end, OPEC couldn't quite agree on a response and ended up keeping production unchanged. "We will produce 30 million barrels a day for the next 6 months, and we will watch to see how the market behaves," said OPEC Secretary-General Abdalla El-Badri after the meeting.

For all intents and purposes, OPEC is now engaged in a "price war" with the United States. What that means is that it's very cheap to pump oil out of places like Saudi Arabia and Kuwait. But it's more expensive to extract oil from shale formations in places like Texas and North Dakota. So as the price of oil keeps falling, some US producers may become unprofitable and go out of business. The result? Oil prices will stabilize and OPEC maintains its market share.

The catch is that no one quite knows how low prices need to go to curb the US shale boom. According to the International Energy Agency, about 4 percent of US shale projects need a price higher than $80 per barrel to stay afloat. But many projects in North Dakota's Bakken formation are profitable so long as prices are above $42 per barrel. We're about to find out how this all shakes out — and how vulnerable the US oil boom is to low prices.

How falling oil prices could affect Russia, Iran, and the US

A plunge in oil prices could have significant economic consequences around the world. A few examples:

Russia: Russia's situation is getting most of the attention these days. The country was already suffering from weak growth — on pace to expand just 0.4 percent in 2014. Part of that was due to the ongoing Ukrainian crisis and Western sanctions.

Russia had been planning for $100-per-barrel oil in its 2015 budget

But the plunge in global oil prices is likely to put even further strain on the nation's economy. Oil revenues account for roughly 45 percent of Russia's budget, and the government's spending plans for 2015 had assumed that prices would stay in the $100-per-barrel range. If oil continues to stay well below that, Russia will either have to draw down its $74 billion foreign-exchange reserves or cut back on planned spending.

Iran: Iran's economy had recently started to rebound after years of recession. The International Monetary Fund had been projecting that the country was on track to grow 1.5 percent this year and 2.3 percent next year. But that was all before oil prices started to drop — a potentially precarious situation for the country.

One big problem for Iran is that it also needs oil prices well north of $100 per barrel to balance its budget, especially since Western sanctions have made it much harder to export crude. If oil prices keep falling, the Iranian government may need to make up revenues elsewhere — say, by paring back domestic fuel subsidies (always an unpopular move, at least in the short term).

The United States: In the US, meanwhile, a fall in crude prices would have more varied impacts. For many people, it will offer a nice economic boost: cheaper oil means lower gasoline prices, giving households more money to spend on other things. On the other hand, oil-producing states like Texas and North Dakota are likely to see a drop in revenues and economic activity. (For more, see: "Which states get hurt most by falling oil prices?")

The price drop could also spur people to start using more oil. Case in point: In recent years, high gasoline prices have spurred many Americans to buy smaller, more efficient cars. But if gasoline prices fall, bigger cars and SUVs could make a comeback. (Overall US fuel economy will still keep rising over time — because the federal government has imposed new standards on cars and light trucks through 2025. But this might now happen more slowly.)

In the *Financial Times*, energy expert Michael Levi has a piece on how the US (and other countries) could take advantage of low oil prices to make needed energy-policy reforms — such as ending wasteful fossil-fuel subsidies or putting in place new efficiency measures — in order to prepare for the day when prices inevitably rise again. But that's hardly guaranteed to happen: Many policymakers might just decide low oil prices are here to stay and use it as an excuse to cut back on efficiency measures or energy alternatives.

Further reading

-- The price of oil is falling right now, but it's not hard to imagine scenarios in which it starts rising again. As energy economist James Hamilton points out, instability in Libya, Iraq, or Nigeria could do it. And, of course, if Canadian and US oil producers pull back sharply in response to lower prices, those prices will eventually stabilize and rebound.