THE OIL PRICE WAR

Michael C. Lynch

March 12, 2020

BIGGEST ONE DAY DROP BEFORE

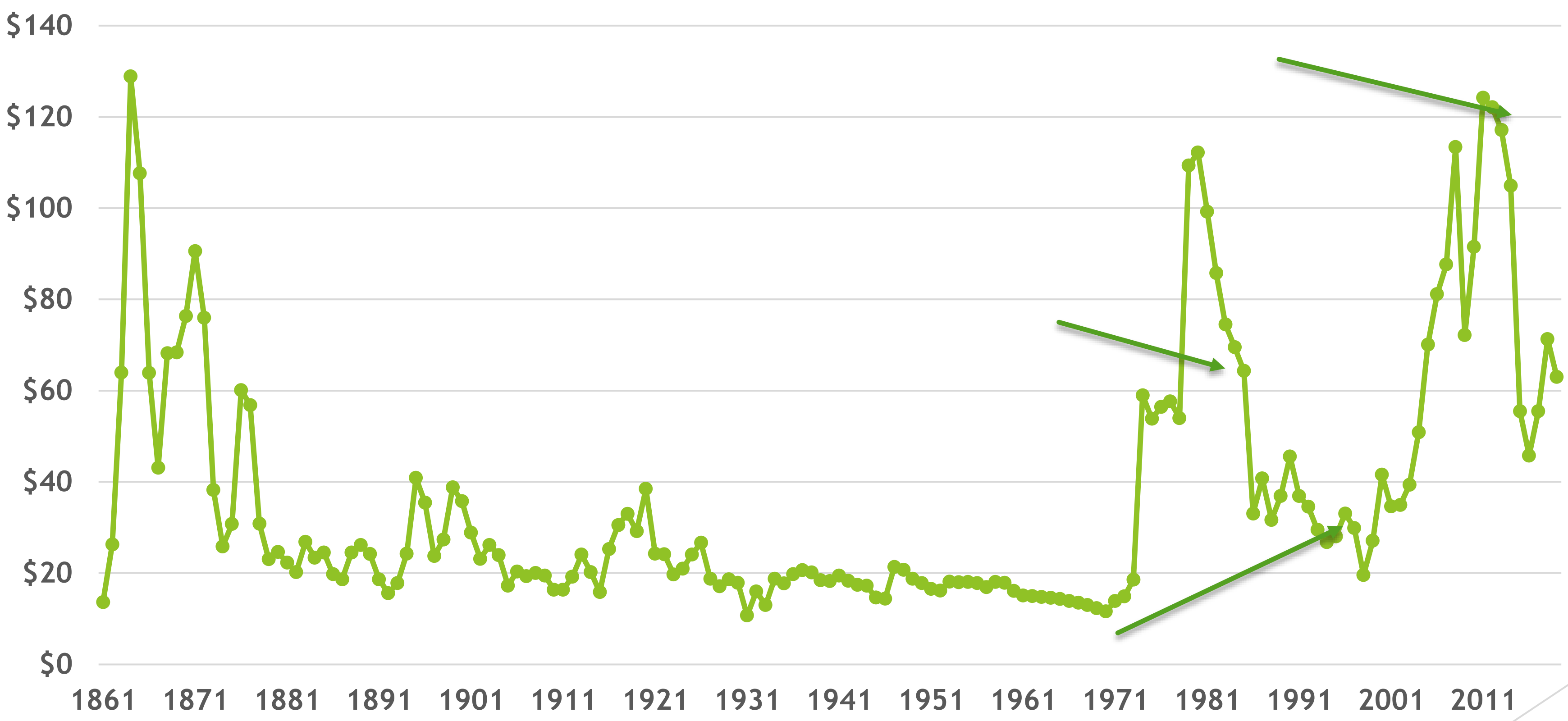
The beginning of bombing during the first Gulf War was the largest previous One day price drop.

HISTORY

- 1985: OPEC UNDER PRESSURE
  - PRODUCTION DROPPED 15 MB/D FROM 1981 TO 1985
  - PRICE ADJUSTED TO SUSTAINABLE LEVEL
- 1998: PRICE WAR
  - OPEC NOT UNDER STRONG PRESSURE, VENEZUELA CHEATING
  - INTERNAL PRICE WAR
- 2014
  - SHALE (AND OTHER) PRESSURE GROWING
  - EXTERNAL PRICE WAR (PASSIVE, NOT A PRODUCTION INCREASE)

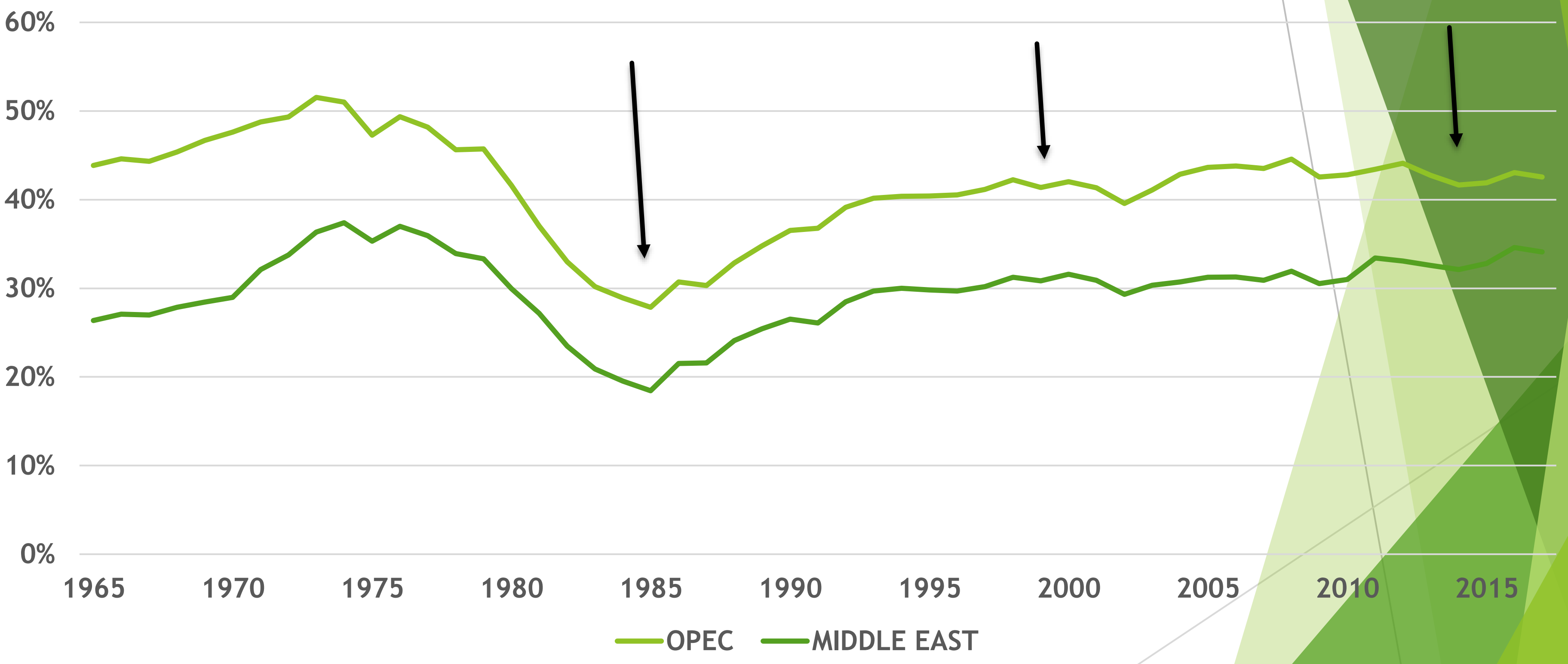
There has never been a consensus that prices were too high. Even in 1985, with Demand for OPEC oil down 50% in 5 years, the consensus was that prices were too low.

THREE OIL PRICE CRASHES



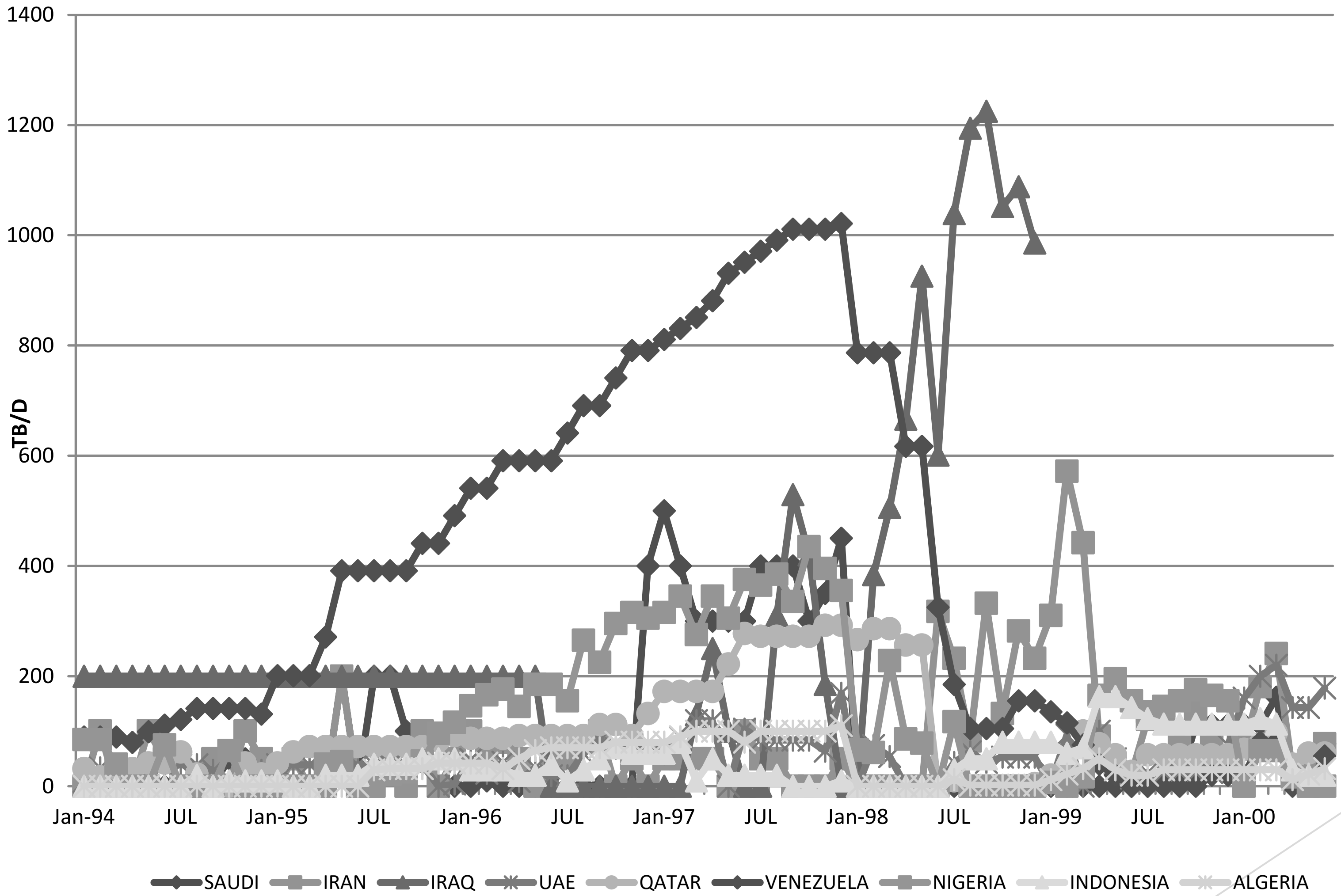
In 1985 and 2014, prices were high. In 1998, prices were low, and it should have been Anticipated that they would recover.

OPEC MARKET SHARE
(AND PRICE CRASHES)



1985 was a clear case of response to external pressure, the others less so.

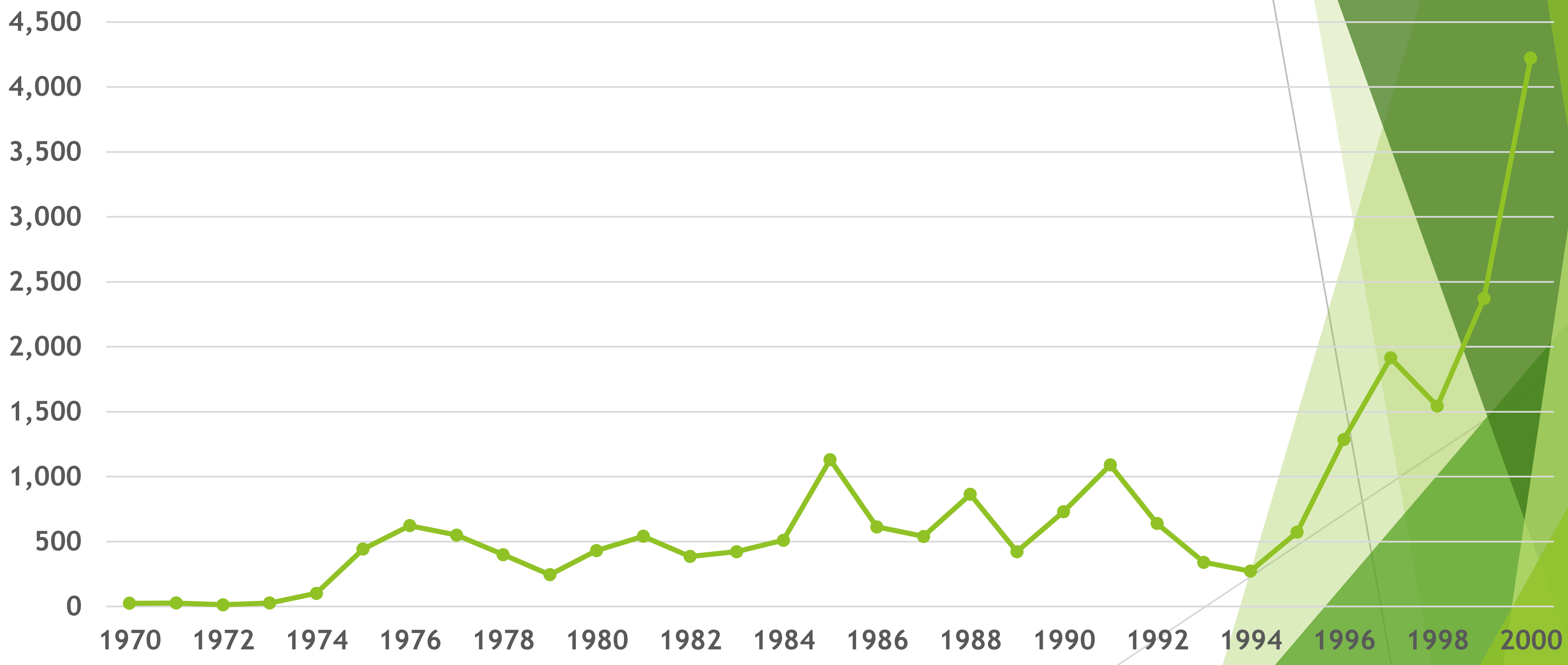
Non-compliance in 1998



In 1998, Venezuela was 1 mb/d over quota and rising, insisting that
It would never again obey a quota, essentially daring the Saudis to start a price ware.

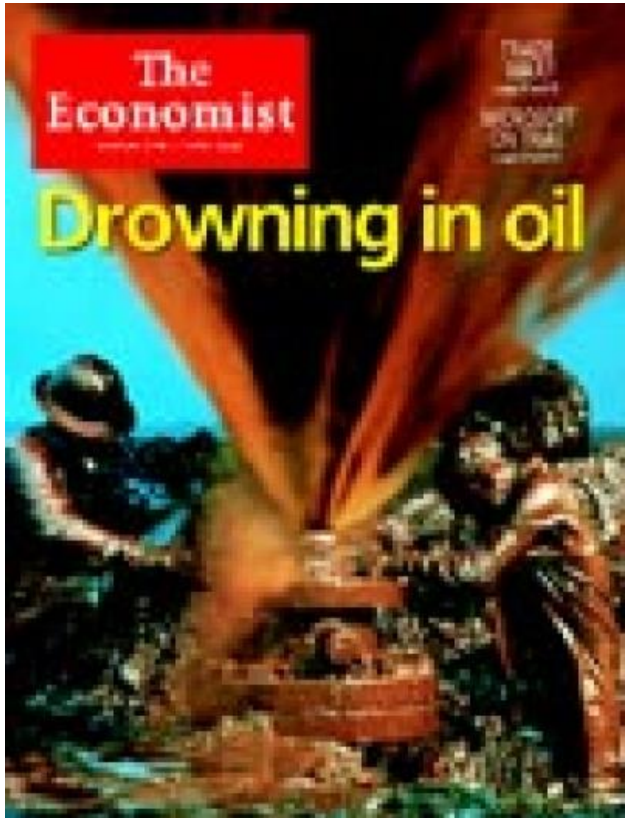
Source: Energy Intelligence Group

OIL SANDS INVESTMENTS



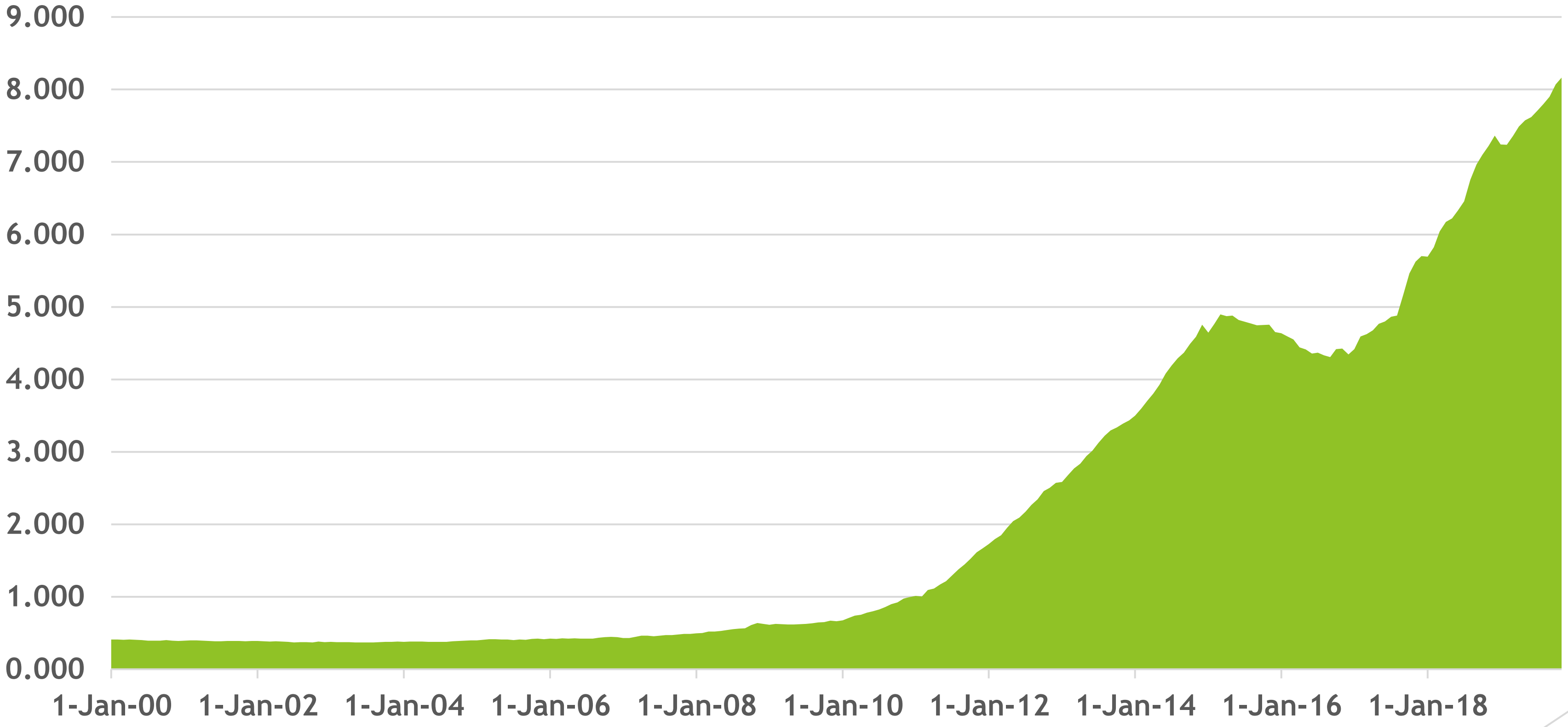
In the mid-1990s, there was a perception that non-OPEC supply would be rising, partly due
To strong production in the North Sea, but also heavy investments in oil sands and Orinoco.

DEJA VU



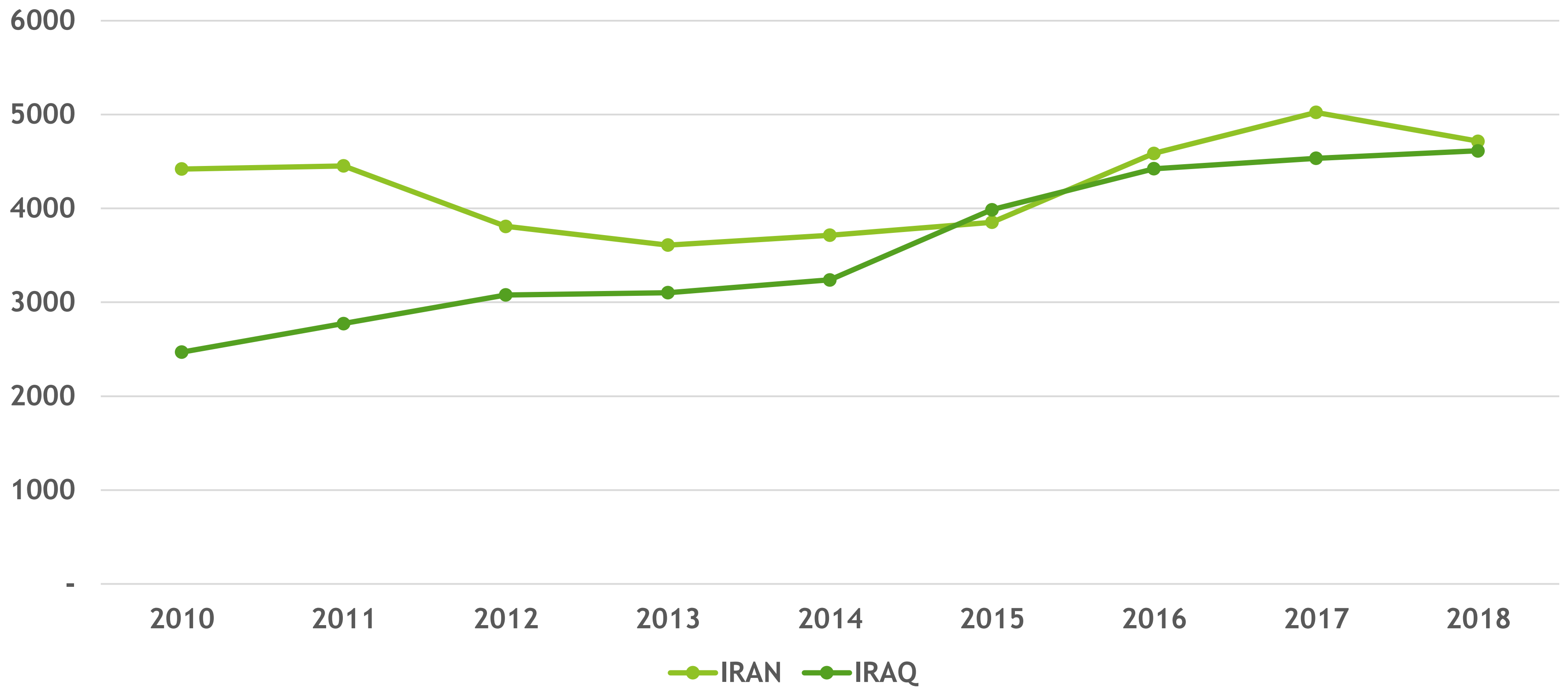
There were at least some observers who thought the $12/barrel price would extend Long beyond 1998.

U.S. SHALE PRODUCTION



The increase in US shale oil production clearly posed a threat to OPEC by 2014
And was the primary reason the market was in glut.

INTERNAL COMPETITION

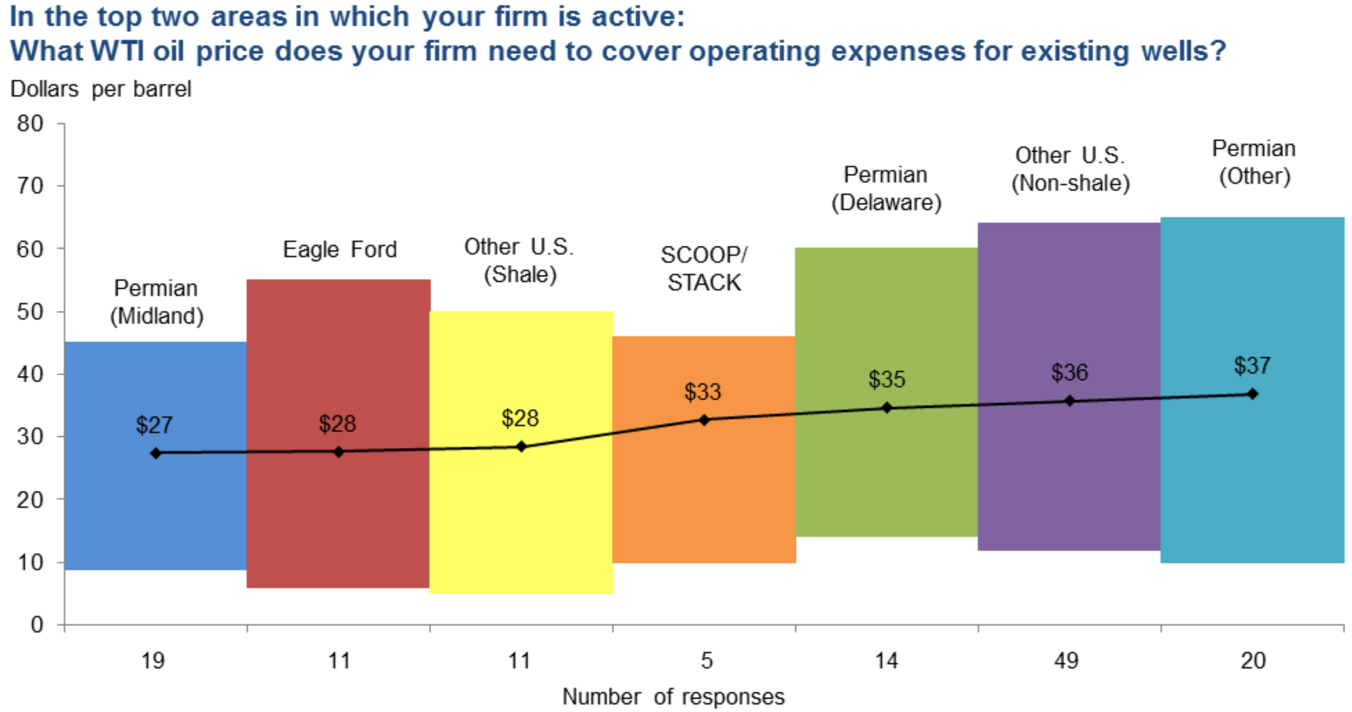


Iraqi production was also rising sharply in 2014/15, and negotiations for a nuclear Agreement that would end sanctions on Iran were well underway. Both countries had Aggressive expansion plans, which might have encouraged the Saudis to let prices fall.

THIS TIME IS DIFFERENT
(JUST LIKE EVERY OTHER TIME)

- STRONG LONG-TERM PRESSURE
  - QUOTAS IN PLACE FOR 3 YEARS
  - QUOTAS NORMALLY USED FOR TRANSIENT WEAKNESS
- SHALE: LARGE SCALE HIGH COST PRODUCTION
  - LOW PRICES COULD SEE MUCH LESS SHALE OIL PRODUCTION
  - MARKET WON'T REBALANCE FROM HIGHER DEMAND (COVID)
- PERSONALITIES
  - ARE PUTIN AND MBS STUDENTS OF GAME THEORY?
- REPUTATION EFFECT
  - WILL OPEC'S CREDIBILITY TAKE A HIT?

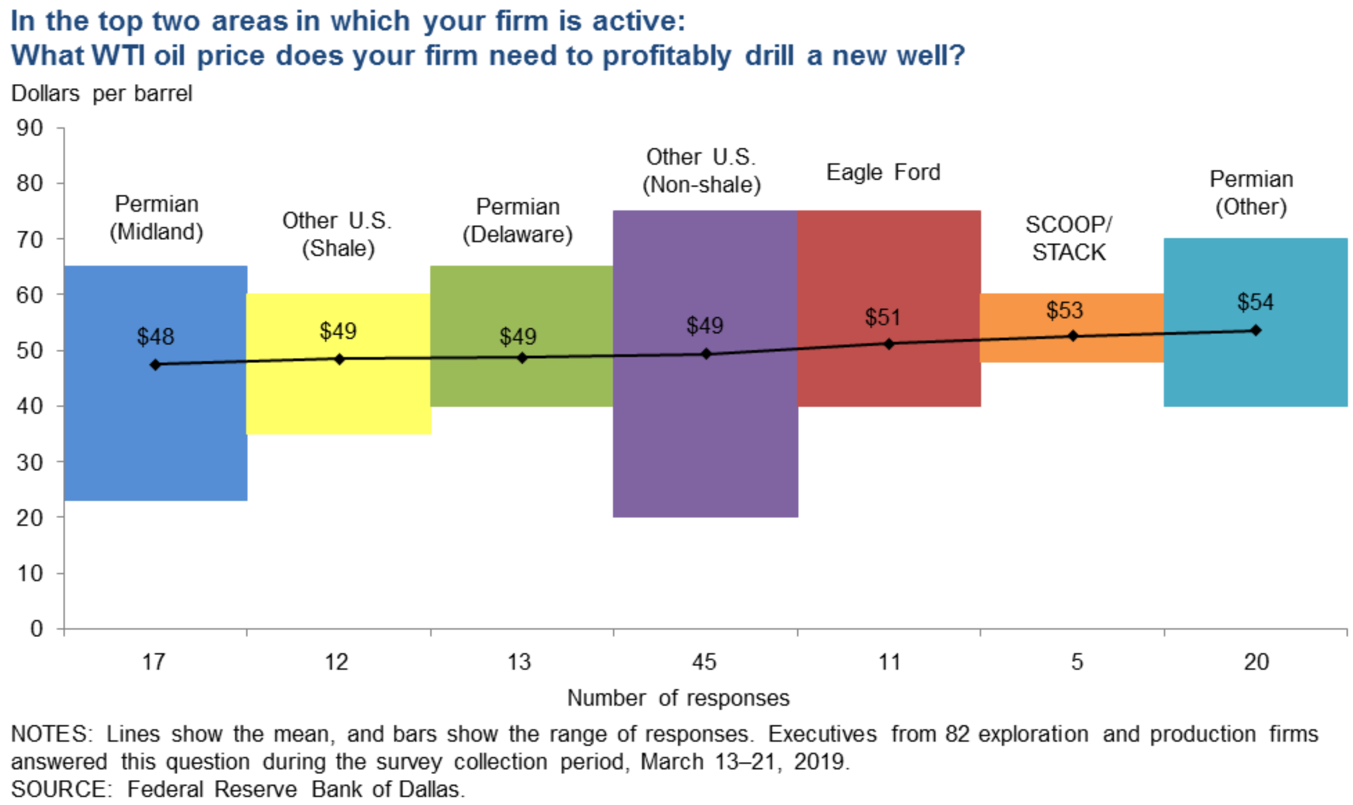
MARGINAL COSTS (SHORT-RUN)



NOTES: Lines show the mean, and bars show the range of responses. Executives from 87 exploration and production firms answered this question during the survey collection period, March 13–21, 2019.
SOURCE: Federal Reserve Bank of Dallas.

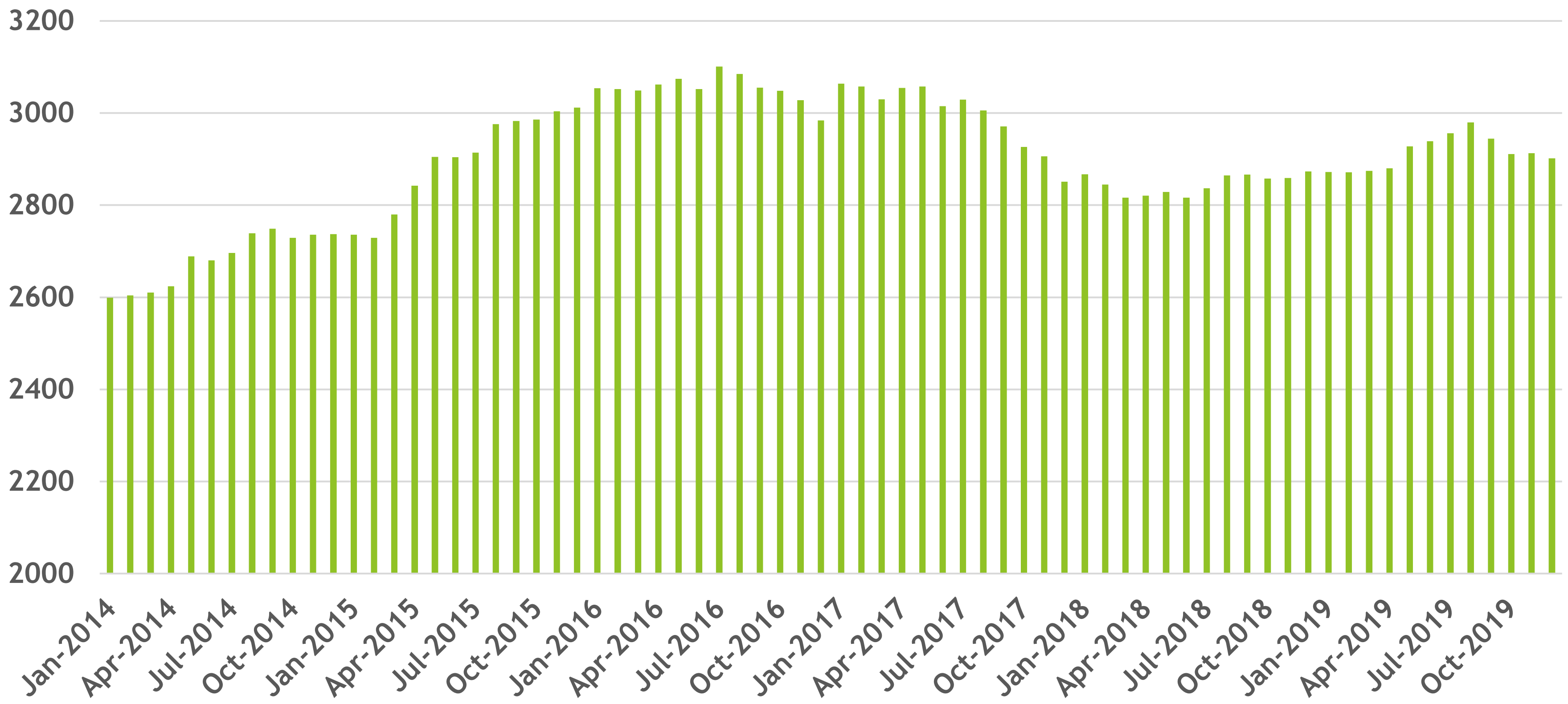
This is an unweighted average but it suggests that at least some shale oil
Would shut down at $35/bbl.

MARGINAL COSTS (LONG-RUN)



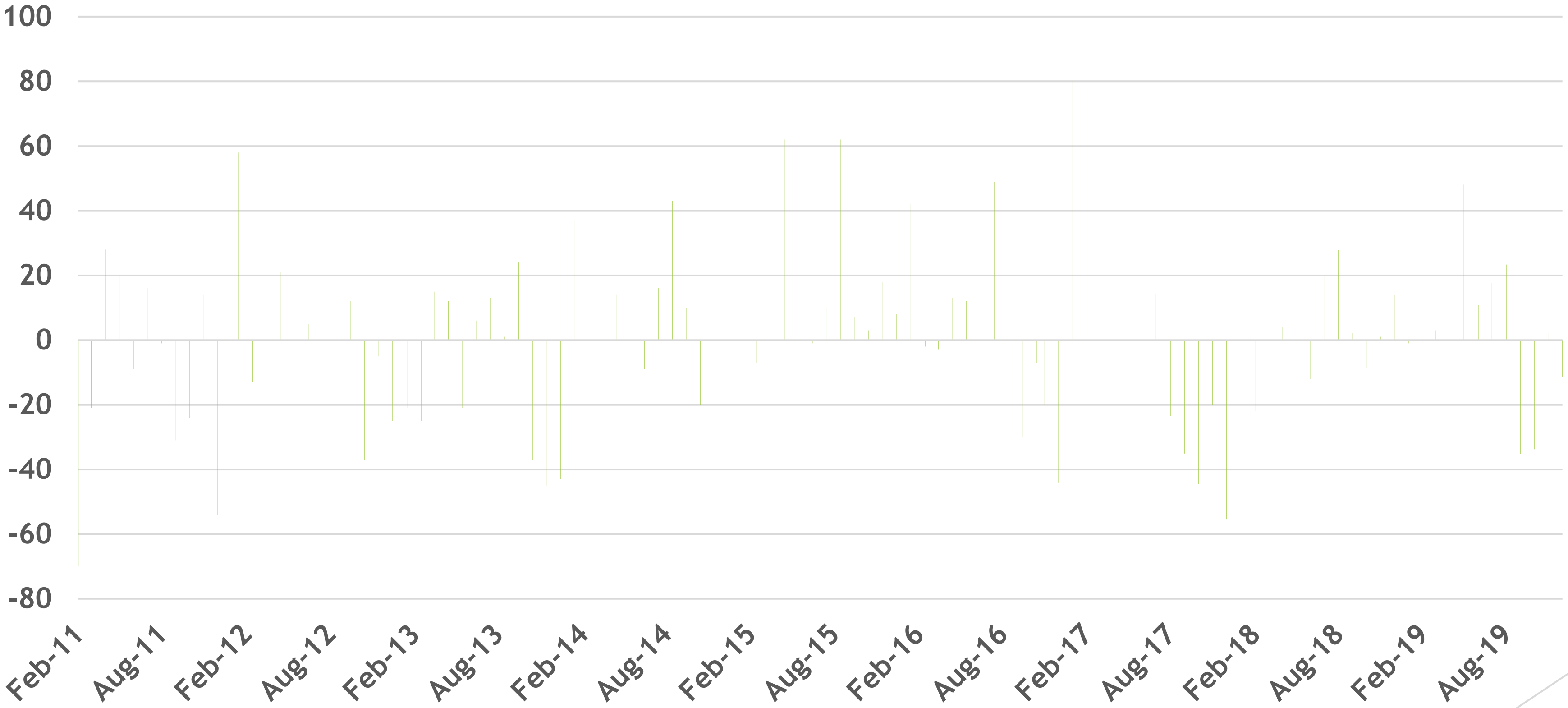
Again, an unweighted average but at $35/barrel, new investment will plummet.

OECD INVENTORIES



Between the demand effect from covid19 and higher Saudi and Russian production, Inventories might increase as much as 150 million barrels a month for two months. Half would probably be seen in OECD inventories; a three month price war would take To record high levels.

MONTHLY INVENTORY CHANGE
(OECD MB)



A 75 million barrel increase per month in the OECD would be extremely bearish.

GEOPOLITICAL EXPLANATION

- LONG USED AS A RATIONALE
  - 1986: EFFORT TO HURT SOVIET UNION PROBABLY UNTRUE
  - IRAN VS SAUDI ARABIA OFTEN CITED, BUT SEEMINGLY COINCIDENTIAL WITH WEAK MARKETS
- RUSSIA VS. SAUDI ARABIA
  - MAYBE, BUT WHY NOW?
- DO OTHER COUNTRIES MATTER?
  - IRAN: SAUDI HAPPY TO HURT, RUSSIA NOT
  - VENEZUELA: RUSSIA NOT HAPPY
  - US/TRUMP UNCLEAR
    - OIL INDUSTRY SUFFERS, CONSUMERS BENEFIT

POSSIBLE OUTCOMES

- U, V OR L SHAPE?
- WHO BLINKS
  - DEPENDS ON GOAL BEHIND THE PRICE WAR
    - PROTECTING MARKET SHARE
    - DISCOURAGING RELIANCE
- SETTING FOR LONGER TERM
  - SHALE RESPONSE PRIMARY