

Oil Prices between Economic Realities and Geopolitical Motives

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Introduction

By mid-November 2014 oil lost almost one-third its price since June.

Much has been written about this dramatic decline in oil prices and different thoughts were offered attempting to explain what has been behind such downward movement.

Undoubtedly the impacts of such decline could be both effective and significant; but such impact depends largely on a complexity of many other factors and the answers to the following critical questions remain unclear: How fast are oil prices moving downwards? How deep they go? Is there a floor/bottom price and what is it? How long that floor price will last?

This intervention addresses first the recent price movement by analysing the linkages that exist between oil prices from their daily trading sessions to their medium term forecast, contending they are closely linked and mutually reinforcing.

The second part attempts to review and assess the main arguments behind the current price deterioration. Three broad arguments are discussed: hard economics, market share and geopolitical motives. The SWOT analyses suggest weak validity of the arguments for market share and geopolitical motives.

In its last part the paper offers brief remarks on the price differentials between Iraqi crudes and Brent and its implication, suggesting further examination of this issue by SOMO/MoO.

Oil Prices Interlinks

When addressing oil pricing movement one needs to be clear and careful, when using data and information, on which crude and what time dimension.

International writings focus generally on WTI and Brent price movements at the trading sessions. In the US, oil is benchmarked against the West Texas Intermediate (WTI) crude oil price (which is set on the New York Mercantile

Exchange - NYMEX in New York) pegged at Cushing hub, Oklahoma. The Brent crude oil price (set in the Intercontinental Exchange (ICE) London) is the benchmark for oil traded in world markets.

Intraday prices for traded oil reflecting trading deals pertaining to Spot, Forward and Future markets and related contracts. These prices vary (up and down) by the hour of a trading session within a day reflecting the prevailing trading sentiments and the effective actors therein (oil traders, brokers, speculators (through “Contango” and “Backwardish” attitude), etc.). These intraday prices are also very sensitive to a variety of different circumstances such as political event, eruption of a conflict, resolution of a conflict, accident on a main pipeline or export terminal, statements, reports, accidents, attacks on an oilfield, natural disasters (earthquakes) and alike in addition to normal trading and future contracts.

When these prices form a pattern of direction (stable/ upward/ downward) within an observed period of time (successive weeks or months) then a trend of the price emerges. The duration and slope of **price trend** reflects much more than trading sentiments but also what is known as market fundamentals, broadly defined.

Finally, there is a **forecasted price**, which estimates future level(s) of oil price based on the observed price trend by using various forecasting techniques and methodologies of different complexity and coverage comprising many variables, factors, assumptions and data.

While the first two types of oil prices reflect trading sentiments and market fundamentals, the projected oil prices are the outcome of the forecasting models, their purpose, their time horizon etc. Different financial entities, banks, investment agencies, international organisations, think-tanks, research institutions, universities, government entities among others are producing a variety of such price projections.

Time-wise, they are quarterly, annually or even much longer. Thus, there are too many of such forecasted prices and the disparity among them could be substantial, as shall be noted hereunder.

But what is important to realize is the three above mentioned prices are closely connected and thus impact each other.

Among these three oil prices the pattern/ trend of oil price has, in the last few months, captured the world attention and caused the apparent recent surge in writings about oil prices.

During such period the prices could move up or down (reflecting the very short time aspects referred to above) at some points in time though the trend or pattern of the movement is upward or downward. The interaction of variety of factors such as market fundamentals, geopolitics and events of global dimensions could play role in shaping the observed trend: speed, depth and duration.

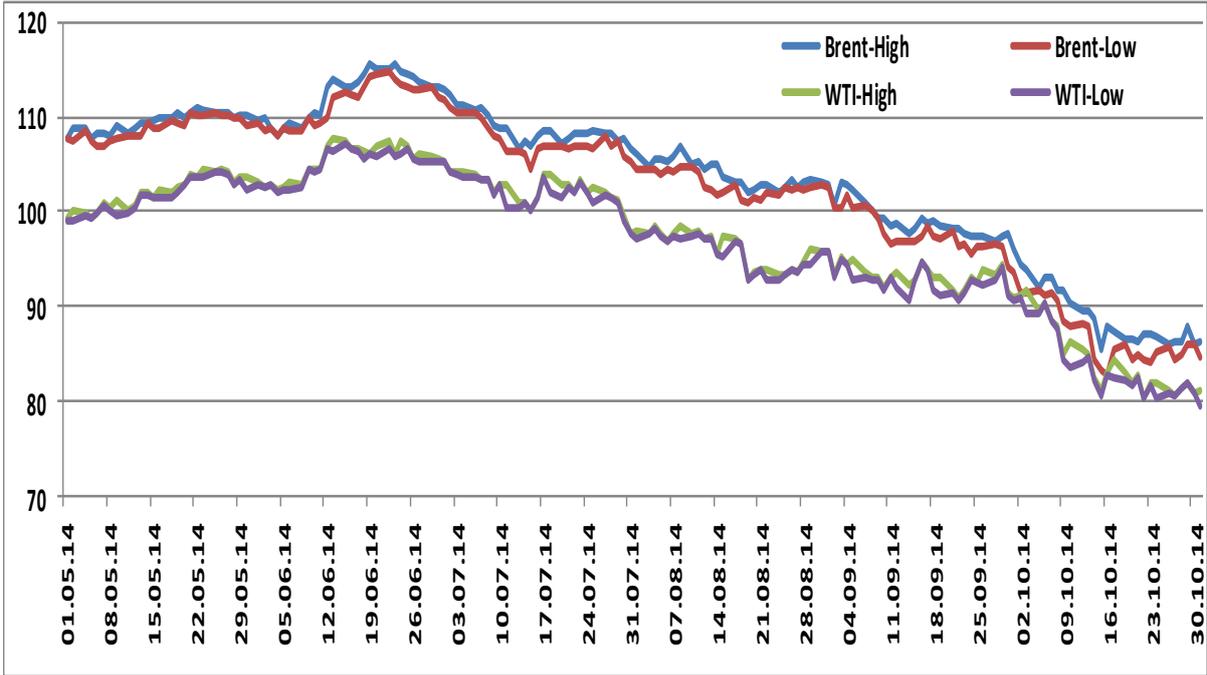
The following Chart 1 illustrates the above and exhibits few tendencies pertaining to the daily trading prices (highest and lowest) and their trends for both Brent and WTI during the period from 1st May to 31 October 2014 using data from Oslo Burse.

First, the daily variation of trading price (lowest vs. highest) for Brent was as low as 7 cents a barrel, while the highest was \$5.07 a barrel; the corresponding variation for WTI was 2 cents and \$2.72 a barrel. The average variation over the observed period between highest and lowest trading price for both crudes was \$1.21/B for Brent and \$0.47/B for WTI. These variations could reflect higher price volatility in the global market (for Brent) than in the US (for WTI);

Second, prices of both crudes were on the upward trend up to 16 June when WTI traded highest at \$106.68/B and June 19 when Brent reached \$115.67/B. Since then the price trend of both crudes went descending; and this persistent and rather steep decline is alarming and thus cause concern.

Finally, the price differentials (Brent over WTI) between highest trading price of both crudes began to decrease reflecting the increasing importance of US domestic production, including the new shale petroleum; the average differential was \$7.3/B when Brent is over \$100/B, but went down to \$5.09/B when the price is under that threshold.

Chart 1: Brent & WTI Daily Trading Prices (\$/B): 1 May - 31 Oct 2014

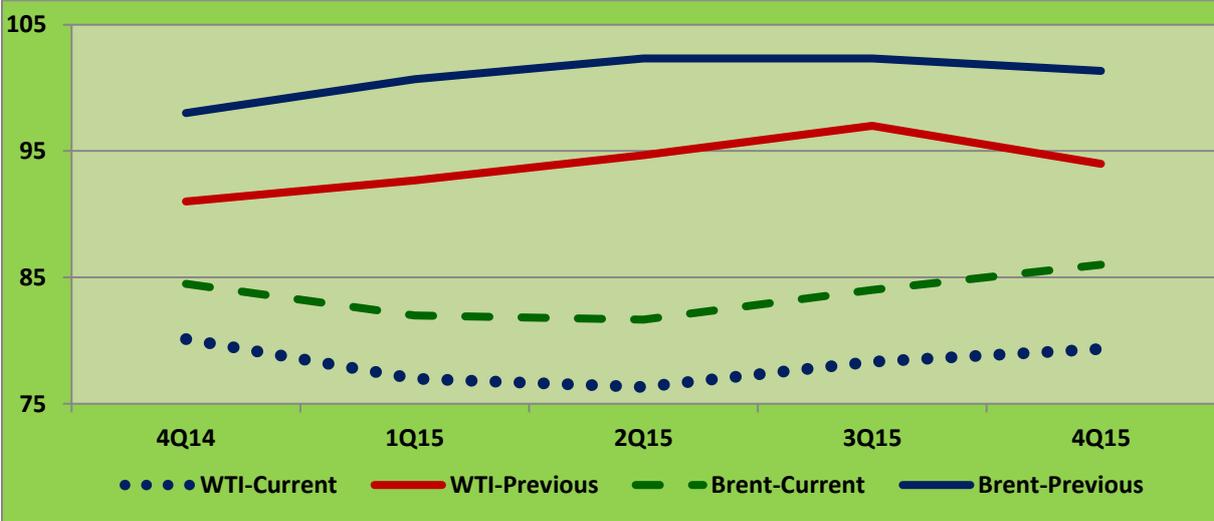


Source: Author’s (AMJ) Compilation based on data from Oslo Bourse (www.oslobors.no)

The persistent decline in WTI and Brent prices since mid-June had compelled many to revise and cut their previous price forecasts. Citygroup reduced its price forecast for 4th quarter 2014 (4Q14) to \$92/B for Brent and to \$83/B for WTI, while EIA projected in its latest forecast (12 Nov 2014) \$84.48 and \$80.13/B for both crude respectively for the same quarter. For 1st quarter 2015 (1Q15) while Barclays reduced its forecast from \$95/B to \$88/B (Brent) and from \$87/B to \$78/B (WTI), Goldman Sachs cuts its forecast from \$100/B to \$85/B (Brent) and from \$90/B to \$75/B (WTI) and EIA revised down its forecast from \$100.67/B to \$82/B (Brent) and from \$92/B to \$77/B (WTI).

As at the time of writing, EIA current forecast (12 Nov 2014) compared with its previous forecast (7 Oct 2014) provides the most complete price forecast on quarterly bases. The following Chart 2 exhibits the quarterly comparative forecasts for Brent and WTI from 4Q14 up to end 2015.

Chart 2: Brent and WTI Price Forecast \$/B (4Q2014-2015)



Source: Author’s (AMJ) Compilation based on EIA data (www.eia.gov)

The comparison between EIA’s November forecast with that for October tells the drastic downward revision especially for 2015. WTI is expected to decline from \$80.13/B in 4Q14 to \$76.33/B in the 2nd quarter next year before recovering very little to reach \$79.33/B in the last quarter 2015. For 2014 as a whole, WTI price will be \$95/B moving down to \$77.75/B in 2015.

The same pattern prevails for Brent. Its price will decline from \$84.48/B in 4Q14 to \$81.67/B in the 2nd quarter next year before moving upward to \$84/B in the 3rd quarter and to \$86/B in the last quarter 2015. For 2014 as a whole, Brent price will be \$101.04/B moving down to \$83.42/B in 2015.

EIA forecast for 2015 is also different from forecasts done by others. For Brent in 2015, Bank of America Merrill Lynch reduced its forecast from \$108/B to \$98/B, while Standard Chartered Bank forecast was down from \$110/B to \$105/B, and finally Newedge Japan forecast is \$95/B in case of OPEC cut otherwise it will be \$75/B without cut.

For the same year, Citygroup WTI forecast down from \$99.5/B to \$89.5/B

The above indicates a high margin of difference in these forecasts for 2015 for Brent; the highest difference could reach \$30/B between Standard Chartered Bank and Newedge Japan (in case of OPEC cut) or \$21.58/B between Standard Chartered Bank and EIA. As for WTI the difference is much lower at only \$1.15/B between Citygroup and EIA.

Such a huge variation in Brent forecasted prices for next year surely causes understandable concerns on the credibility and viability of these forecasts on one hand and increases uncertainty on the likelihood of price level on the other. Also when these forecasts are released they usually impact the prices on the daily trading sessions, which in turn impact the trend of the price and the latter contribute to impact the forecasted price (as evidenced by EIA November revision). Hence there is cyclical interlinks between these three prices that enforce each other. But when forecasted prices are so diverge it would be difficult to have realistic projection for the pace, depth and duration of oil price levels, thus causing further uncertainty in the market and volatility in the price.

So what has actually caused these dramatic declines in oil price since June 2014 and forecasted to continue on this trend? This takes us to discuss the main arguments explaining these declines.

Understanding the Current Price Decline: Three Broad Arguments

Oil pricing is a complex issue affected by multiplicity of factors, too many actors, have wide and sometimes diverse effects and implications, and above all it relates to a strategic and globally critical commodity- depleting natural resource: hydrocarbons (oil and gas).

The recent descending trend in oil prices can be explained many school of thoughts presented by numerous articles on this issue during the last few months. These can be grouped in three broad arguments covering hard economics, market share and geopolitical motives, reflecting divers understanding and propositions. In the following space I will address them briefly.

Hard Economics Argument

Subscribers to this argument focus on variety and broad category comprising economic, financial and trade factors that stood behind the current decline in oil prices, and impacts its future trend and development.

The main premises of the hard economics arguments rest on the analyses which assert, among other things, the following:

- that growth in global petroleum supply has been running at more than double the pace of demand growth; that growth of supplies occurs in OPEC and non-OPEC countries (mainly the US) alike;

- that such growth of supplies includes both conventional and non-conventional petroleum (especially due to fracking and tight-oil technologies);
- that potential for growth in demand on petroleum is centred more in the Asian (especially east) region;
- that China is increasing its oil stockpiling (taking advantage of low oil prices); that US Strategic Petroleum Reserve- SPR is, officially, approaching three times the required under IEA obligations;
- that US supply of light and sweet crudes has created a glut of this kind of oil globally and imbalance between sour and sweet crudes and thus render OPEC action ineffective;
- that global growth in demand on petroleum is unlikely to match its supplies in the immediate future, though OPEC assert that final figures for global manufacturing in October confirm that the world economy continues to recover gradually, and thus positively impacting oil consumption, especially in some emerging and developing economies;
- the return to the market of previously disrupted Libyan crude oil production;
- strong dollar, low interest rates and other fiscal measures and economic performance in the OECD countries and China have their role too.

Thus, the proponent of this argument say, oil supplies surplus (glut) had contributed to declining oil prices and such decline could remain or even deepen as long as this glut persists.

To capture price decline, stabilize it and/or, if possible, reverse it upward entails, at least, eliminating current supply surpluses; and the burden to do so rest upon OPEC, specifically on the largest producer Saudi Arabia, and Kuwait and UAE who have been producing at “maximum capacity”, while other OPEC members (especially Iran, Iraq, Libya, Nigeria, Venezuela) are facing serious difficulties impacting their production levels.

This leads us to deal with the second argument.

Market Share Argument

The foregoing argument suggests or implies that OPEC has to choose between two options: defending an oil price at certain level (by agreeing on and strictly adhering to collective output ceiling for 2015 lower (by 0.5 to 1.5mbd) than its (formal) level of 30mbd (though actually it stands at 30.25mbd at end October); or do nothing thus leaving oil price deteriorating further.

Some analysts anticipate that Saudi Arabia and other GCC' OPEC members would adopt and defend their "market share" and thus causing further slid in oil prices.

The proponents of this proposition formulate their opinion on three premises: historical precedence; collection of recent specific signals from and actions taken by GCC's OPEC members – even when oil prices are already on the sliding trend; and on the financial affordability tolerating the burden of lower oil prices.

Historically, Saudi Arabia, leading other GCC's OPEC members, had in 1986 (after OPEC's "fair market share" - July 1985) pursued market share argument thus compromised prices leading to it collapse to \$6/B. Then in 1989/9 (at the wake of Asia debt crises) Saudi Arabia was ready to compromise oil prices again on the pretext of market share unless others (within OPEC and outside it) share the burden in cutting output; It, they argue, could do the same again this time and other OPEC members are (or should be) aware of such eventuality.

Recently, Saudi Arabia and other GCC's OPEC members gave clear signals and took actions that could indicate to the same behaviour of maintaining market share.

So far the most clear and effective signals and actions include the followings. On Monday 3rd November Saudi Arabia cut prices for US deliveries to crowd-out imports from Canada, Mexico and Venezuela, and also to interrupt US shale oil producers. Earlier, Saudi Aramco announced, on 2nd October, that it was cutting prices by about \$1 a barrel to Asia and by 40 cents a barrel to the US. That move was to impact the Nigerian crude, which was diverted from US markets due to increasing US production of similar light, sweet crude; Saudi Arabia has formally informed OPEC Secretariat that the kingdom had increased its output by 100kbd; and Saudi Arabia has privately told oil markets that it is ready to accept oil prices perhaps down to \$80 a barrel.

Also the Kuwait's oil minister, Ali Al-Omair, was quoted as saying that OPEC is unlikely to cut oil production in an effort to prop up prices because such a move would not necessarily be effective. And the head of Kuwait's national oil company said that his country had no plans to cut output, even as prices fell below \$83 a barrel.

Finally, financial affordability premise is formulated on the fact that while Saudi Arabia, the UAE, Kuwait and Qatar all have significant sovereign assets and cash reserves to bank on during a period of lower oil revenues, the impact will be felt much harder by other OPEC member countries especially Iran, Iraq, Libya and Venezuela.

As mentioned earlier many industry analysts and GCC officials think that Saudi Arabia (and other GCC OPEC members) might pursue the market share instead of defending oil prices, and could use this opportunity to attain political objectives. This leads us to review the geopolitical motives argument.

The Geopolitical Motives Argument

Oil market sensitivity to geopolitics has gone through two broad phases: an apparent reaction in the first and a lack of it in the second; the first phase ended by mid-June to give way for the second that lasts up to date. That seems to be connected to the dramatic events in Iraq, when ISIS (or better known in Arabic by Daesh) swept the city of Mosul on 9/10 June and what followed that event. Initially, some suggested (then) that “Even the slightest disruption in supply could send oil to \$200 a barrel overnight”. Now, many commentators suggest that geopolitical concerns are taking a back seat in impacting oil prices, though most of global hot political disturbances are close to significant energy locations (mainly MENA).

This, paradoxically, prompts many to suggest that such conditions offer Saudi Arabia with a good opportunity- through lowering oil prices- to pursue and attain geopolitical objectives. Thus, as one commentator puts it, “It’s hardly surprising, then, that the recent precipitous drop in global oil prices has generated a flurry of conspiracy theories”.

Leaving conspiracy (reconstruction) theorists and populist commentators aside, the main geopolitical arguments that have been circulated in business, analyses and media circles are three. One suggests that Saudi Arabia intends to punish Russia for its supporting to Bashar Al-Assad in Syria. A second one extends the first by including Iran to Russia (some adds Iraq while others include Venezuela).

These two sub-arguments assume or imply that U.S and Saudi Arabia are on one side by deliberate (plot!) or a coincidence of interests (opportunists). Within this group many refer to the impacts of 1985/6 price crash that “brought-down” the former Soviet Union, and thus they revisited and reiterated Cold-War era’ politics and rhetoric, inducing Saudi Arabia to act on this direction.

A third sub-geopolitical argument suggests that the intention of Saudi Arabia is to limit the expansion of the US unconventional oil production (due to fracking) and its role in the international oil market. Obviously, this argument contradicts the first two concerning US-SA collaboration.

Since international low oil price does not shield a country and confine its effect on selected countries, the above three geopolitical motives sub-arguments are in fact closely connected and practically inseparable, leading to a multi-objectives argument comprises all the above three despite the apparent contradiction and inconsistency.

Analytically, the above three broad arguments- hard economics, market share and geopolitical motives- could interconnected. This in a way indicates to the complexity, multiplicity and diversity of conditions, factors and policies that could have significant impacts on oil (petroleum) price; and thus it is rather immature to confine the analyses to one or narrow explanation only.

That said, the strength of “hard economics” arguments is the credibility and verification of the comprehensive and solid statistics, data, information, projects, policies among others that reflects the dynamics of the global energy balance and related policies.

Contrary to that, the pivotal role in the “market share” and “geopolitical motives” arguments is Saudi Arabia, requiring confrontational zero-sum behavior towards OPEC and the US alike! Thus, these two broad arguments are based more on perception and desired action that could be taken, or not, by that country; and this is a major weakness common to these two ways of thinking. Moreover, one could argue that Saudi Arabia’ market share was consolidated over the last four decades on the expense of other OPEC member countries: on Iraq and Iraq since 1980 due to the war between these two countries; on Iraq during the sanction era of 1990s and the invasion of Iraq of 2003 to date; on Iran since the imposition of current sanction linked to the country’s nuclear program; and Libya since the downfall of Gaddafi in 2011. All three countries (Iraq, Iran and Libya) are currently producing much lower than what they did at the end of 1970s. Also, production in Venezuela has steadily declined to around 2.4 million barrels — about the same level as it was in the 1960s.

Therefore, these four countries have also strong historically verified claim for their market share within OPEC. On the other hand UAE and Kuwait are already producing at maximum capacity, thus have no room (in the short to medium

terms) to expand (with lower oil prices). Other OPEC members with limited capacities will have similar problem with market share arguments.

Obviously, within OPEC market share only Saudi Arabia has, supposedly, the capacity to maintaining or expanding its market share against the interest of all other members; thus the next OPEC meeting on 27 Nov could be heated and acrimonious if the Saudis insist on their position.

Situation in 2014 is very different, in many aspects, from those prevailed in 1985/6 when the Saudis caused that infamous price collapse, which many advocates of geopolitical motives referred to its impacts on the former Soviet Union. The changed circumstances have implications to all major countries mentioned by the advocates of this argument, namely Saudi Arabia on one side and Iran, Russia and the US on the other.

Saudi Arabia itself today has its strengths but also weaknesses and vulnerability. Its strengths are confined to two important matters: oil production spare capacity and the accumulated financial assets.

It is a common knowledge that the country has a spare capacity of more than 2mbd, giving the country a status of the “swing producer”. This, however, is questioned by a long-serving market analyst who asserts, “There is no evidence that Saudi Arabia has deliberately developed large new fields simply to allow them to left idle "just in case" there is a supply interruption elsewhere in the world”, and suggests that, “most of the spare capacity has been in the form of reduced output from older fields as new ones have come onstream. (John Kemp, Reuters, 14 October 2014).

Even if we assume that there is a 2mbd spare production capacity, the impact of such capacity on export is reduced by the growing domestic, which took in 2013 27% of total oil production (BP, Statistical Review 2014). Moreover, domestic consumption usually increases during the long summer season with extreme high temperature causing soaring demand of highly subsidised electricity. This suggests that the kingdom could use whatever spare capacity it has only during the short “winter” time in the country.

The kingdom’ accumulated financial assets are reported to be in the tune of \$1 trillion, and according to Sovereign Wealth Fund Institute-SWFI October 2014 update, the Saudi Arabia Monetary Agency-SAMA alone has \$757 billion (SWFI, October update, 2014).

But the country has almost \$1trillion worth of projects. The current Ninth Development Plan has \$385 billion of investments in social and economic infrastructure between 2010 and 2014, and the Tenth Development Plan will be released later in the year with probably higher allocation. (Hossam Abougabal, AmeInfo, 6 Nov 2014)

In addition to development plans investment requirements there are other significant financial requirement to finance state operating budgets, the gigantic military and armament purchases and financing of operations outside the kingdom among other. All these requirements would eat-up considerable junk of the accumulated financial assets in case of lower oil prices and export revenues.

The country is also vulnerable to many serious challenges internally and regionally (within GCC and the Middle East) that could limit the ability of the kingdom to pursue its multi-objective geopolitics above mentioned.

The “House of Saud” is facing succession problem as the first liners to the royal throne end with current King Abdullah (aged ca. 90) and this could create fraction or infighting for power within the ruling family. Saudi interventionist policies in the regional affairs were in the past more quiet and covert, while it has been in recent years more overt, outspoken and intrusive, thus exposing its regional foreign policy to scrutiny and reaction domestically and regionally. The Saudi society could be not, anymore, shield from the effects of the region’s social movements, political dramatic events, civil wars and armed conflicts in the wake of the so-called Arab Spring that swept the region since the fall of Ben Ali in Tunisia. The wide penetration of internet and social media have revealed many tendencies of disenchantment within the Saudi society and undermined the tacit social contract formulated by the ruling establishment. The \$36 billion worth of welfare promises of 2011 on the occasion of King Abdulla return after surgery operations was one example by the ruling family to dampen any call for serious political change and reform (Madawi Al-Rasheed, Foreign Policy, 28 Feb 2011).

Unlike the 1980s, nowadays Saudi Arabia is facing serious internal threats from both Al-Qaida and ISIS/Daesh (which many accused the Saudis themselves for financing these two and other similar terrorist groups). On the wake of a recent attack in an Eastern province the Interior Ministry announced that it has uncovered a terrorist cell comprising 33 members intended to launch attacks on public entities and high government officials. Other Saudi sources assert that

eleven of such “terrorist cells” have been uncovered lately (Almayadeen TV- 8 Nov 2014). A recent (15 Nov) statement by ISIS/Daesh mentioned, for the first time, Saudi Arabia as one of its immediate target!

The GCC was at its early years by mid-eighties and the solidarity among its members was at its peak with Saudi Arabia as the unchallenged leader. Today, the GCC is split and deeply divide. There is still serious doubt about the venue of the GCC Summit scheduled for 9 December in Doha; the Saudi-Qatari divide intensified with Bahrain and UAE siding openly with Saudi Arabia while Kuwait and Oman stand in the middle; Oman plays overt and covert role in the Iranian-US rapprochement with or without Saudi consent (latest is Muscat meetings in 9-11 Nov 2014 comprising Iran, the EU and US); the Saudi forces have been in the Bahraini capital, Manama, for few years; and finally, the decision by Saudi Arabia to close unilaterally (20 October 2014) the Khafji offshore oilfield, which produces between 280 kbd and 300kbd in the neutral zone jointly run with Kuwait, had strained relationship between the two countries.

The political development in Yemen that enhanced the *Hutheis* position in the power structure in the country poses serious source of concerns on the southern Saudi borders.

A recent pipeline minor incident inside the kingdom caused immediate temporary surge in the international oil prices, but this should be noted and taken seriously. Judging by experience in Iraq, Yemen and Egypt, pipelines are easy targets for sabotage and terrorist attacks. With vast, desert, almost empty areas the Saudi pipelines could be soft targets but with high profile making them priority targets for terrorist within the kingdom or even outside it in other GCC members.

The above are few brief issues indicating to considerable vulnerability of Saudi Arabia and might compel the kingdom to be much more careful in its close regional geopolitical motives.

Leaving Saudi Arabia I will address briefly the three countries-Iran, Russia and the US, which the Saudis geopolitical motives intend to impact them. Undoubtedly, current UN, EU and US sanctions have daunting impacts on the Iranian economy in general and petroleum sector in particular. Further declines

in oil prices would exacerbate the economic situation even further. But Iran today is, generally, much stronger and in a better situation than it was in 1985/6 during its war with Iraq. Also the country has adapted itself against the current sanction. But despite its economic difficulties, Iran has created National Development Fund (NDF) replacing its Stabilization Fund; NDF is funded by earmarking 20% of oil revenues and has accumulated already \$62 billion (SWFI, October update, 2014).

Resolution of the negotiation, with 24 Nov deadline, pertaining to its nuclear programme could ease or lift the sanction. The recent (6 Nov) fourth letter from US President to Iran's Supreme Leader could expedite the rapprochement between the two countries. If things move that way, they would strengthen Iran and consolidate its standing in the face of lower oil price, and thus eradicate the Saudi geopolitical motives.

The Ukraine crisis prompted the US and EU to impose sanction on Russia and increased the likelihood of another cold war. These sanctions, as is the case with Iran, inflict serious damages on Russia causing noticeable capital outflow, according to Russian Central Bank, and weekend the Ruble.

But again, Russia today is economically, structurally and politically very different, and probably stronger, than former Soviet Union of 1985/6.

Russian FDI inward stock increased from \$32 billion to \$576 billion between 2000 and 2013. Similarly, Russian FDI outward stock increased during the same period from \$20 billion to \$501 billion (UNCTAD-WIR 2014). The country's reserves of gold have, according to IMF, increased in September 2014 by 37 tones, reaching 1149 tones; and the country's financial sovereign assets stand at \$187 billion divided between the Russian Welfare Fund (\$88 billion), Reserve Fund (\$86 billion) and Russian Direct Investment Fund (\$13 billion) (SWFI, October update, 2014).

Russian oil and gas is now penetrating aggressively East Asian market as well as Europeans. Major agreements signed in the past 15 months between Russian and Chinese companies are "credit-positive for the Russian oil and gas companies," according to analyst at Moody's Investment Service. (OGJ, 2 Sept 2014). The Russian new branded crude ESPO, after the name of the East Siberia-Pacific Ocean-ESPO crude oil export pipeline, has competitive qualities (it is a fairly sweet, medium-light blend, with a gravity of 35°API and 0.5% sulfur content.) and price. Also the latest gas deal with Ukraine (30 October) has payments funded and guaranteed in part by Kyiv's Western creditors, EU and IMF.

Internationally, Russia is important member of the emerging BRICS and Shanghai Group of countries in addition to the 21 members of Asia-Pacific Economic Cooperation-APEC, G20 among other important international fora providing wide and significant partnerships.

Nevertheless, low and prolonged oil prices could generate serious negative consequences on the Russian economy but again that depends on how deep the price will go and for how long it remains there. The test will be seen on the draws on the country's sovereign financial assets and state budget for 2015.

The third country on the geopolitical motives list is the US. The Saudi intention is directed, according to these advocates, at US unconventional (shale and tight oil). Their argument suggest that by lowering oil prices these high cost producers will be crowded-out leaving more room for the Saudi oil in the American market.

At the outset one could argue that Saudi Arabia will most likely face formidable difficulties in realizing this objective for variety of reasons.

The “fracking revolution” is more than just increase in production of light, tight oil-LTO, which is qualitatively much better than the Saudi crude; it is an outcome of various scientific, technologies, techniques, innovations, and production modalities; involving hundreds of companies, R&D institutions, banks and investors (institutional, corporate and private equities); employing thousands of employees; introducing significant shifts in North American energy profile-refinery configuration, pipelines, transport and export potential, among others.

The direct link of lower oil prices on LTO production is the breakeven price of the individual producing firms at different plays and location.

Breakeven price for producing unconventional oil (LTO) varies among different producing localities and many estimates were reported by various sources, as discussed soon.

For each producer, breakeven price is the price below which it incurs losses. Hence there is no “one” breakeven price applicable to all producers since each could have different production and cost functions.

Generally, breakeven price should be equal to the firm's operating cost, broadly defined to cover of all inputs including the cost (interest rate) and installment of sunk capital (loans). Thus, individual producers are usually very careful in assessing and estimating their own breakeven price as this decides their course

of action. In this regards each producer faces three critical situations when breakeven price equals operating cost. In the short to medium terms, production could continue at “current” level as long as breakeven price equals operating cost. But “planned” (and not committed/ contracted) expansion will be put on hold due to risk and uncertainty; and, no decision on “new” investment will be taken unless breakeven price is assured. But with such declining trend in oil prices both planned and new investment suffer most, assuming no breakthrough, or restructuring the firms or through merger and acquisition (M&A) or any other way that could reduce operating cost/ lower the firm’ breakeven.

Therefore, theoretically and practically, the negative impacts of low oil prices on unconventional oil could be neither immediate nor unified on all producers.

The key tight crude regions – Bakken, Eagle Ford, Haynesville, Marcellus, Niobrara, Permian and Utica – accounted for 95% of domestic US oil production growth. A Baker Institute study estimates that production from the main three plays: Bakken, Permian and Eagle ford was planned to increase from 541kbd in 2012 to 1.254mbd in 2014, forecasted to move gradually to 2mbd by 2020. Thus, future production from these three and others will most likely be interrupted if current price of oil deteriorate further. One estimate suggests that these three production regions have, in 2014, different ranges of breakeven price: it is within \$45-\$50/B for Eagle Ford; \$55-\$60/B for Permian Basin and \$40-\$50/B for Bakken. (MEES, 17 Oct 2014).

Other estimates suggest across-the-board threshold. Maria van der Hoeven, executive director of the International Energy Agency-IEA told Reuters recently, "Some 98 percent of crude oil and condensates from the United States have a breakeven price of below \$80 and 82 percent had a breakeven price of \$60 or lower,"; Wood Mackenzie asserts that producers in many unconventional plays can still make a profit with futures prices for benchmark light, sweet crude oil fetching a price less than \$80/B;

In its recent report (November 2014), Gaffney Cline & Associates explains the complex relationship between the pace of shale production and falling futures prices for light, sweet crude oil. Oil prices in the low-to-mid \$80/B range will allow a lot of US unconventional oil activity to continue, but a further drop could start to have a significant impact on the market and industries associated with it.

The importance of unconventional oil for the US economy has been highlighted vividly by American Petroleum Institute- API and the government Energy Information Agency- EIA.

Seniors executives from API and EIA assert that innovations in shale and tight oil, mostly done by independent producers, were responsible for about 48% of the US crude oil production and speculate that without this new American production prices would be about \$150 a barrel (OGJ, 4 Nov 2014). One source estimates that during the first half of 2014 there were 21500 Shale wells producing at 125 barrel per well, and 558000 [stripper] wells producing other oil at much lower productivity of 10 barrels. (George S. Littell, 2014).

The country has also sizable recoverable of such resources. The EIA, in its Annual Energy Outlook 2014, estimates that US has approximately 610 Tcf of technically recoverable shale natural gas resources and 59 billion barrels of technically recoverable tight oil resources. As a result, the United States is ranked second globally after Russia in shale oil resources and is ranked fourth globally after China, Argentina and Algeria in shale natural gas resources. Despite the current low oil prices PanAtlantic Exploration Co., believes that for the coming 5 years unconventional plays will be dominating new investment, particularly private equity, and doubts that current prices levels will be prolonged.

It is therefore difficult, if not impossible, politically for the American Administration to accept that Saudi Arabia damages US domestic oil production after all what has been achieved. It is worth, in this juncture, recalling the events pertaining to 1985/6 price collapse. When the price plummeted to \$6/B and while the then US President Reagan triumphantly declaring, “We have succeeded in bringing that infamous cartel OPEC to its knees”, his Vice President George Bush (Snr) was lobbying King Fahd, and with whom he agreed that the price should be corrected upward to \$18/B. Thus, that price collapse short-lived. (Fadhil J. Chalabi, 2010).

What prompted the American oil diplomacy to protect domestic production from thousands of “Stripper wells” in the 1980s could do the same for LTO of now. And the Saudis know that! It was only in February 2014, Dr. Ibrahim al-Muhanna, Senior Advisor to Saudi Arabia’s Minister of Oil, elaborated on why Saudi Arabia welcomes the US Shale Boom (MEES, 07March.2014). More recent, incidental or not, the Saudi Arabian Oil Minister Ali al-Naimi broke months of silence to reaffirm the “kingdom's long-standing policy of seeking

stable global markets, dismissing talk of a price war.” (Upstreamonline, 12 Nov 2014). Does the ministry of oil have different view from other power centres in the kingdom?

Finally, since lower oil price impacts are not discriminatory (they could not intend adversaries and protect allays simultaneously), they are bound to impacts harder the development prospects of unconventional oil and renewable energy in other parts of the world.

The brief SWOT (Strengths, Weaknesses, Objectives and Threats) analysis outline above would suggest that the Saudi Arabia geopolitical motives and market share arguments have less likelihood of a glorified success, let alone a prolonged one.

Let me conclude this part by reiterating the complexity of oil price movement since June 2014 and the three broad arguments explaining such trend. However, there is no consensus on how far down oil price will go; how fast; what is the bottom price and for how long it remains before reversing course upward? These are essential questions with no clear answers, so far. But OPEC ministerial meeting on 27 November could clear the view slightly!

Iraqi Crude-Brent Price Differentials

Price setting mechanism in Iraq covers type of crude and market destination by using different equations. Generally, there are two types of crude (Basra and Kirkuk) and three market destinations: East Asia, Europe and the US.

Accordingly, current SOMO’ price matrix comprises, technically, six formulas plus one for trucked supplies to Jordan, which is interrupted by the security situation since mid-June 2014. From next year the price matrix will cover nine formulas due to splitting Basra crude into two light and heavy.

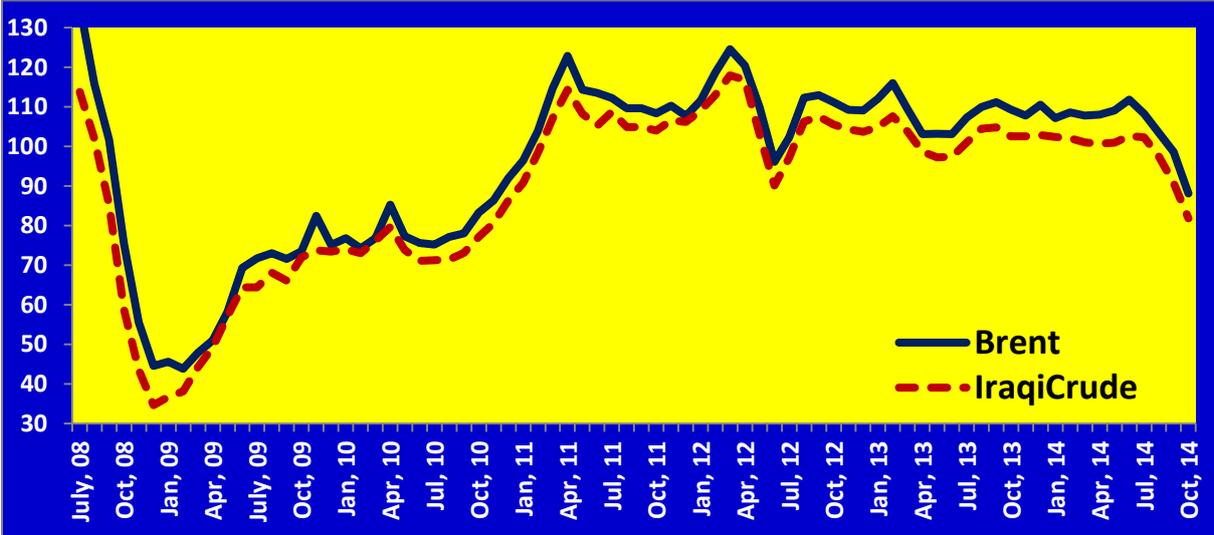
The price formula/equation for each market destination has a specific “marker crude” and other variables reflecting qualitative aspects of the exported crude (in terms of API and other contents) transportation cost etc.

The “marker crude” for Asian markets is “Oman/Dubai average”; for the US is “Argus Sour Crude Index -ASCI” and for Europe is “Dated Brent”.

All these are reflected in the actual shipment lifted from oil export terminals on the Gulf, and Ceyhan-Turkey; the trucking deliveries to Jordan are governed by special bilateral agreement.

Therefore, what the MoO and SOMO announce monthly reflects the “average” of actual oil prices of actual oil exports. However, there is strong correlation between the average of Iraqi exported oil price and Brent. The following chart 3 exhibits such close relation between these two prices.

Chart 3: Brent and Iraqi exported oil price (\$/B): July 2008- Oct 2014



Source: Author’s (AMJ) Compilation based on data from Oslo Bourse (for Brent prices) and MoO (for Iraqi oil export prices)

The above chart shows that Iraqi crude price has been always lower than Brent, and this is expected reflecting the quality of the Iraqi crudes and its pricing mechanism. Moreover, all Iraqi exports are done through sales contracts (Term contracts) with pre-selected international oil buyers (IOBs), which their names are published on monthly bases. SOMO does not deal with oil brokers, spot traders and does not sale at spot price.

During the period January 2009 to October 2014 the price differentials (Brent-Iraqi price) varied between \$0.60 and \$9.25 a barrel. Moreover, though the differential varies monthly the trend line clearly shows increasing differentials, as Chart 4 demonstrates. This could be explained by the negative effects of blending practices (of lower API or fuel oil) by SOMO; the reduced contribution of Kirkuk crude (which has better API than Basra blend) during 2013 and complete closer since March this year; or by both. If these differentials are due to blending of Basra crude then splitting it into two light and heavy, starting from January 2015 is well justified.

Chart 4: Price differentials- Brent-Iraq exported oil price (\$/B): Jan 2009- Oct 2014.



Source: Author’s (AMJ) Compilation from Chart 3 above.

The trend line (in red) indicates that price for Iraqi crude could be lower than Brent, on average, by \$7 a barrel in 2015. But this requires further and careful examination by SOMO and the ministry since both, supposedly, have better and more comprehensive database than what I used for this paper; and the above mentioned planned splitting of Basra crude into two as from January 2015.

Norway.
17 November 2014.