The Good News About Lower Oil Prices!

By Fereidun Fesharaki*

While many fear low oil prices and worry about its negative impacts, we must also consider its positive attributes.

High oil prices at US$100/bbl or higher makes everything in the energy space work! Both good projects and bad projects—from expensive non-conventional oil to exotic energies to expensive LNG projects.

The last few years, when oil prices hovered between US$100 to $110/bbl, it gave the market a false sense of security that this was the long-term oil price. It was not the norm, it was an aberration! Many bad decisions were made on the basis of high oil prices. OPEC countries increased subsidies and gave away huge chunks of money. IOCs engaged in expensive acquisitions, especially in non-conventional oil/gas. Contractors gold-plated their work and jacked up prices. Even energy consultants did not have to add value. If they had an upstream service, they could bill whatever they wanted. The shale frenzy in the United States added to the gold rush. Costs escalated and people acted as if there was no tomorrow.

Just like losing weight can improve your health, lower oil prices can make you more efficient and productive. It can bring back rational decision making based on sound economics, not just depending on high oil prices to make projects profitable.

Lower oil prices will have a positive impact on certain oil-producing countries. The larger oil producers—Venezuela, Nigeria, Algeria, and Iran—will certainly suffer, but even they can reduce their subsidies and be more efficient. In the Middle East, lower oil prices to say, US$60-80/bbl are manageable. Indeed, they can be very positive. Subsidies have distorted the long-term supply and demand in these countries so much it harms their economies. Indeed, the subsidies have changed the demand pattern so dramatically that it is difficult to fix the problem. Many inefficient industries based on natural gas have been set up. They should have never been built if there were a rational pricing system in place, but now they will insist on continuing to receive subsides indefinitely because otherwise they will go bankrupt.

Smuggling has become rampant. Oil is smuggled from one subsidized country to another less subsidized country. No one is brave enough to tackle the root cause of the problem because with high oil prices, the governments feel they have to give back to the population a portion of the revenues through subsidies.

The demand growth for oil in the Gulf countries in 2014 is greater than the incremental growth in China—all because of subsidized prices. Huge refineries are being built in the Gulf with justification that this is for supplying the domestic market, even if in reality it will eventually be an export refinery. This presupposes the subsidies continue forever! Many Middle East oil producers have become gas importers because gas prices are so low. Some burn large volumes of crude oil because gas supplies are not sufficient. Saudi Arabia’s oil demand surpasses Iran’s, although Iran has several times the population. The curse of high oil prices has made rational decision making more and more difficult.

Amongst the positive attributes of lower oil prices and tighter budgets, a few are listed below:

- A push for partial removal of subsidies. Full removal is still a long way away.
- No need for large new refineries. Indeed lower subsidies and higher domestic prices will result in lower absolute demand and much lower future growth. This means that many of the so-called domestic refineries will become export refineries. There will be no need for new refineries with the label of “strategic investment” under a low oil price regime.
- No more uneconomic and inefficient energy-using industries will be built.
- Wasteful mega-projects will slowly disappear.
- Budgets will be rationalized based on lower prices with far less waste and inefficiency.
- Lower oil prices will make the governments far more accountable to the people.
- Need for financing and loans from outside will subject projects to better international scrutiny.
- Reduction in unnecessary and wasteful job creation with little or sometimes negative impact on the economy.
- Reduction in massive military expenditures.

Historically, the best decisions in the Middle East have been made at the time of lower oil prices.

Amongst the private companies, especially those in the upstream oil business, with heavy investments in unconventional oil/ gas, and expensive LNG projects, the sense of reality sets in. Where LNG is concerned, the key question becomes “can you develop and deliver LNG to the market at US$11-12/mmBtu?” If you

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cannot, then, you need to step back, rethink the project, and perhaps postpone or cancel it. The old concept of whatever I spend is ok with high oil prices is no longer valid. This may postpone or cancel some projects, but it cleanses the system from irrational and uneconomic behavior.

How long do we need to see low oil prices to change direction? The price of oil has moved to the US$80/bbl range for some time to come. It may well end up in the US$55-65/bbl range for a year or two, but US$80/bbl is still a long-term floor. The difference between US$100/bbl and US$80/bbl is quite substantial for decision making.

The world will be a better place with lower oil prices. No oil producer will ever prefer lower prices to higher prices, but lower prices will do everyone a good service. They bring common sense back to the decision-making process!

Letters to the Editors

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In that light, and in response to suggestions from readers, the Editors are pleased to announce that, beginning with the March 2015 issue, EEEP will add a section of "Letters to the Editors." Readers are invited to submit letters of not more than two pages (i.e., not more than 1000 words) concisely and impersonally reacting to articles appearing in EEEP. Letters submitted will be judged for publication on the basis of brevity, clarity, and strength of argument, and the Editors reserve the right to edit them further to those ends. In some cases, they may be forwarded to the original article's author(s) for a response to be published at the same time. Anonymous letters will not be considered.

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