# OPEC decision a shot in oil price war

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**28 November 2014**

Yesterday's decision by the international oil cartel OPEC, led by Saudi Arabia, not to cut production in the face of plummeting oil prices will have a major impact on the energy industry, with possible significant ramifications for the global financial system as well.

Immediately on the news that OPEC will maintain production levels at 30 million barrels a day, the price of oil fell a further 8 percent to around $70 per barrel, bringing the total decline to almost 40 percent since June.

The tumbling oil price is a product of two factors: increased US production from the exploitation of shale oil, and falling growth and stagnation in much of the world economy, which has led to a decline in demand. The falling price will be compounded by the Saudi-led move, which is clearly directed at undercutting the US shale oil industry.

The decision's most immediate consequences will be felt in Venezuela, Algeria and Iran, all OPEC members, where government revenues depend on oil prices remaining at around the level of $100 per barrel, where they sat from 2011 until the slide began in June.

Venezuela and Algeria were pushing for production cuts by OPEC of around 2 million barrels per day.

Russia, which is not an OPEC member, is also likely to be severely affected. With sanctions on its economy having a significant effect, Russia needs an oil price of between $80 and $100 per barrel to balance its budget.

The Saudi reaction to the slump is in marked contrast to its actions in response to the global financial crisis of 2008, when there was a downturn in the oil price. Then it led the way in carrying out production cuts, resulting in the price rising to $100 a barrel in 2011.

A significant change has come over energy markets since then. The extraction of shale oil and gas in the US has largely taken it out of the market as an energy importer. Imports are predicted to provide only 21 percent of US liquid fuel consumption next year, compared to 60 percent in 2005.

But the expansion of the costly shale oil extraction industry was predicated on oil prices remaining above around $80 per barrel. Once the price starts to fall below that level, marginal producers are seriously impacted.

According to many market observers, the Saudis decided not to curb production in the belief that elevating the price would only further increase production from the United States, causing OPEC to lose more of its share of global markets.

In fact, the decision may have been taken with the express purpose of further lowering prices in order to hit the US industry. This is a tactic being pursued in the iron ore market where low-cost producers, such as BHP-Billiton and Rio Tinto, are increasing production levels, even in the face of a declining market, in the hope of forcing higher-cost producers to the wall.

The aggressive intent of the Saudi actions was the theme of a number of comments on the decision. Kuwaiti Oil Minister Ali Saleh al-Omair said OPEC would have to accept any market price, even if it were as low as $60.

Others were even more blunt. "We interpret this as Saudi Arabia selling the idea that oil prices in the short term need to go lower, with a floor set at $60 per barrel in order to have more stability in the years ahead at $80 plus," Oliver Jakob from Petromax consultancy told Reuters. "In other words, it should be in the interests of OPEC to live with lower prices for a little while in order to slow down development projects in the United States."

Russian oil tycoon Leonid Fedun, the vice president of OAO Lukoil, said the OPEC policy would ensure a crash in the US shale industry. At today's prices of around $70 per barrel drilling was close to unprofitable for many producers, he said, adding that OPEC's objective was "cleaning up the American market" where the shale boom was on a par with the dot.com bubble.

Research by JP Morgan Asset Management concluded that of the 12 largest shale oil basins in the US, some 80 percent are barely profitable at prices lower that $80 per barrel.

However, the drive to wipe out higher-cost US shale producers could have far-reaching consequences for global financial markets. Energy projects in the United

States have been heavily financed through the issuing of high-risk or junk bonds. In 2010, energy and materials companies made up 18 percent of the US high-index yield, a measure of so-called sub-investment grade borrowers. Today they account for 29 percent, as a result of massive borrowing by drilling companies.

Research carried out by Deutsche Bank showed that should the price fall to $60 per barrel, which is eminently possible, there could be a default rate as high as 30 percent among some US borrowers.

A report published earlier this month in the British *Telegraph* warned that the "rush to pump more oil in the US has created a dangerous debt bubble in a notoriously volatile segment of corporate credit markets, which could pose a wider systemic risk in the world's biggest economy."

Evidence of the oil price slide's impact on major banks came to light in an article published in yesterday's *Financial Times*. It reported that two major banks, Barclays and Wells Fargo, faced "potentially heavy losses on an $850 million loan made to two oil and gas companies, in a sign of how the dramatic slide in the price of oil is beginning to reverberate through the wider economy."

The report also noted that of the 180 distressed bonds in the Bank of America Merrill Lynch high-yield index, some 52, or nearly 29 percent, were issued by energy companies.

The shale oil boom in the US has been hailed as demonstrating how the American economy, through ingenuity and innovation, is powering ahead, even as the rest of the world experiences stagnation or recession. But it could well turn out to be the source of another major financial crisis in the US and globally.