LOS ANGELES
Daily Journal
www.dailyjournal.com
THURSDAY, FEBRUARY 4, 2016

What's next for oil's new economy?

By Jonathan Michaels

There are few commodities in the world that affect daily life like oil. It's just everywhere. The easy application is gasoline, but the list beyond that is mind-numbing. Oil is used to make plastic, cosmetics, detergent, nylon and a host of other non-obvious consumer goods we use on a daily basis. So when the price of oil drops, its impact ricochets throughout the economy.

Oil didn't kill the economy in 2008, but it made every effort to snuff out its last breath. At the time, the U.S. was consuming a world-leading 20 million barrels a day, while producing a mere 5 million barrels. The delta of 15 million barrels we imported on a daily basis traded at $145 per barrel, yielding a net loss to our local economy of $800 billion per year. For an economy that was down, the blow was near fatal.

But the world's oil market has changed dramatically in the past decade, driven largely by new U.S. oil exploration techniques that allow us to extract oil once thought unrecoverable. The technique is called hydraulic fracturing, aka "fracking," a process where rock is fractured by hydraulically pressurized liquid made of sand, water and chemicals, allowing oil to flow through the fractured rock horizontally.

Thanks to fracking, the U.S. has become the world leader in oil production — surpassing historical giants Saudi Arabia and Russia — churning out a massive 14 million barrels per day. Because of a refusal to change our usage habits (we still consume 19 million barrels daily), the U.S. still has a deficit of 5 million barrels per day. But the gap is closing considerably.

U.S. oil production has also been chiefly responsible for driving down the world's price oil to its current rate of $30 per barrel. The impact on U.S. consumers has been dramatic. The national average for gasoline is hovering at $1.79 per gallon, the lowest in years, and a far cry from the U.S. historical high of $4.41 in 2008.

The low price of gasoline has helped the U.S. auto industry rocket to a historical high of 17.5 million vehicles sold in 2015, besting the prior high of 17.4 million in 2000. The auto industry, which employs some 8 million Americans, has been a major contributing factor to our bright economy.

And it is likely to get better. The International Energy Agency estimates that 2016 will experience an oversupply of oil to the tune of 1.5 million barrels per day, and industry experts close to the situation expect oil to drop to $20 a barrel, further stripping down costs across all sectors. Some are even more bullish, such as the Royal Bank of Scotland, who predicts a price of $16 per barrel — a price not seen since 1946. Such levels would rip through consumer prices like nothing in recent memory.

New York Times

Pumps in the Midway Sunset, an oil field operational for over a century, near Fellows, Calif., in 2013.

The historical low price of oil leaves a lingering question of why it is being allowed to exist. Those old enough to have witnessed the 1970s will remember with great angst how beholden we were to the 12 OPEC nations (Algeria, Angola, Ecuador, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, the United Arab Emirates and Venezuela), as embargos were put in place against the U.S. in 1973.

Responding to U.S. involvement in the 1973 Yom Kippur War, the oil-rich OPEC countries cut supply to the U.S., raising prices by 400 percent virtually overnight. The dramatic reduction in supply caused the U.S. economy to immediately seize, leading to the 1973 stock market crash — the first slap-down to the U.S. economy since the Great Depression.

For Saudi Arabia, the current downturn in oil prices is starving out its economy. Located in a wasteland desert where no man should live, Saudi Arabia is a one trick pony whose economy rises and falls with the price of oil. Despite its efforts at diversification, oil remains accountable for 80 percent of the country's revenue.

With 270 billion barrels in proven reserves, compared to the U.S.'s 25 billion, Saudi Arabia leads the world in political clout and has the ability to trim supply all the way up the demand curve. So, given that it's economy is tethered to the price of oil, why in the world would it not do so?

The answer appears to lie in the Saudis' efforts to break the back of the American oil industry, by keeping prices low in the hope of driving out U.S. oil pioneers. It is ironic, but it was oil prices that brought in a bevy of new petroleum explores; now it is the prices that are driving them out.

When oil was trading at $145 per barrel in 2008, extracting it from hard to reach places began to make a lot of sense, and the fracking industry exploded in the oil rich states of North Dakota and Texas. But fracking is terribly expensive. For every barrel produced by Saudi Arabia, U.S. shale drillers spend 10 to 15 times as much to extract the same amount. Saudi Arabia is willing to endure the pain, betting that it will break the new found U.S. oil industry.

The Federal Reserve estimates that the nation has lost 70,000 oil production jobs in the last three months, and it will likely not get better for the oil states anytime soon. Industry experts say that prices need to stay at at least $60 per barrel for fracking to remain viable. Current prices of $30 per barrel, and worse, predictions of $20 or lower, are killing the local industry.

If Saudi Arabia is right, taking the pain now will produce long term benefits for the Arab nation, as it and the other OPEC nations will again control the world's supply of oil, and ultimately its price — that is, until new technologies make shale drilling more affordable.

As our rebound from the 2008 economic crisis begins to cool, the question of what will happen with the price of oil is one that should concern us all. With U.S. consumption far outstripping any other nation, our economic outlook will, to a large degree, be tied to the price of oil and our ability to become self-reliant. We have made tremendous strides, but much is yet to be done. As William Shakespeare famously said, "It is not in the stars to hold our destiny, but in ourselves."

Jonathan Michaels *is the founding member of MLG Automotive Law, APLC, which specializes in representing clients in the automotive industry. You can reach him at (949) 581-6900 or jmichaels@mlgautomotivelaw.com*