
Trump Pressure to Lower Oil Prices Will Backfire

Cheaper gasoline benefit outweighed by producer losses.

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Data Sources for This Publication

U.S. Energy Information Administration

CME Group

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Negative Impact Could Escalate Rapidly

President Trump has publicly demanded that Saudi Arabia lower crude prices – implying they shouldn't agree to OPEC production cuts—in return for his support for embattled Crown Prince Mohammed Bin Salman over the Jamal Khashoggi murder. Over Thanksgiving (Nov. 21) the president tweeted thanks to Saudi Arabia for oil prices falling to \$54 per barrel that were "like a big tax cut for America and the world." Prices for U.S. benchmark West Texas Intermediate fell 33% between Oct. 3 and last Friday Nov. 30 to \$50.93. Over the same period, New York Harbor prompt-month unleaded gasoline prices fell 33% to \$1.44 per gallon with many retail gas stations now selling for less than \$2 per gallon. Obviously, American consumers gain from falling gasoline prices, but at the same time, U.S. producers lose revenue as crude falls. Our analysis shows that since September 2017, losses for crude producers have outpaced gains from lower gas prices. This week we explain why the United States loses out from lower crude prices and how the negative impact could escalate rapidly if domestic production is curtailed.

OPEC Meeting

This note is published after the G20 Summit meeting in Buenos Aires on Nov. 30 and before the OPEC meeting in Vienna on Dec. 6. Crude oil prices have been in free fall since early October because surging supplies threaten to overwhelm demand growth next year as we described two weeks ago (see "[End of a Bullish Cycle? Crude Runup Hits Supply Wall](#)"). At that time, we pointed to the need for OPEC and its partner Russia to impose production discipline in Vienna to prop up falling prices. Since then, Trump has criticized any attempt at oil price support from Saudi Arabia, further weakening prices in the runup to the OPEC meeting this week.

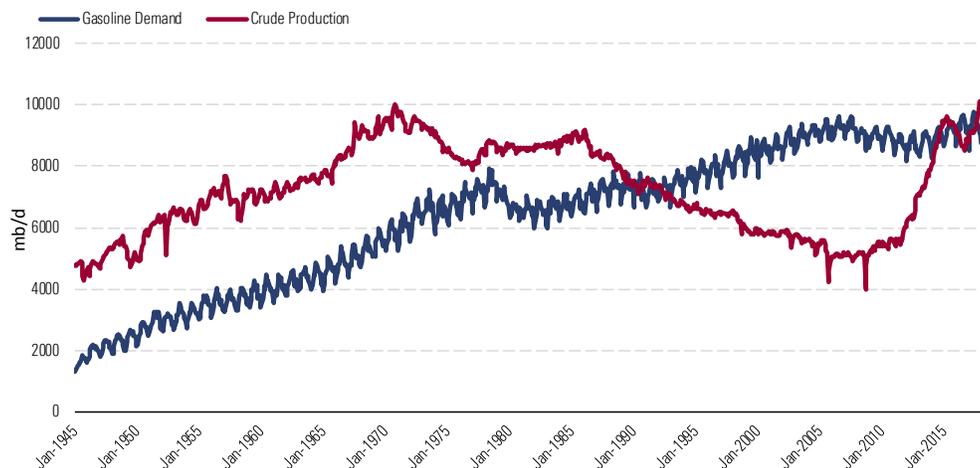
News from the G20 Summit indicates Saudi Arabia and Russia agreed to continue production discipline during 2019 although no details have emerged. It remains to be seen how President Trump will respond to further OPEC cuts. Meanwhile crude prices are recovering this morning in Europe.

Crude Producers Lose More Than Consumers Gain

The rationale of Trump's intervention on oil prices is based on providing immediate benefit to U.S. consumers in the shape of lower gasoline prices. So far, this benefit has been rapid and real with wholesale gasoline prices falling 33% since early October highs—good news at the pump and for the headline writers. However, looking at the U.S. economy, the consumer gain at the pump is now actually a net loss by one measure because domestic crude producers lose more money from lower oil prices. Our analysis compares U.S. domestic crude production against domestic demand for gasoline (defined as product supplied) on a monthly basis using Energy Information Administration data. Exhibit 1 shows EIA data since January 1945 when U.S. crude production of 4.7 million barrels per day was nearly 4

times gasoline consumption of 1.3 mmb/d. In the pre-shale era, crude production peaked in 1970 and then began a long decline until 2009. Gasoline consumption has been on an upward trend throughout the postwar period. Sometime in the late 1980s crude production fell below gasoline consumption in volume terms and remained that way until the shale era. The dramatic recovery in crude production during the first shale boom between 2011 and 2015 saw output power back above gasoline consumption by October 2014 when crude output was 9.2 mmb/d and gasoline 9.1 mmb/d. Crude remained slightly ahead of gasoline until May 2015 when production fell in response to the late 2014 price crash. Crude prices and production began to recover in October 2016 and output has jumped by 3.0 mmb/d since then to 11.5 mmb/d in September 2018 (latest monthly data). Crude output pipped gasoline demand in January and February 2017, jumping ahead again in September 2017 and has remained in front ever since. The latest EIA preliminary data for the week ended Nov. 23 has crude production at 11.7 mmb/d and gasoline demand at 9.2 mmb/d.

Exhibit 1 U.S. Crude Production and Gasoline Demand



Source: Morningstar, EIA.

Our analysis assumes that a fall in crude prices has a net benefit to consumers equal to (fall in gas price X gasoline sales volume). During the period between Oct. 3 and Nov. 30, gasoline prices for CME NYMEX New York Harbor unleaded fell by 70 cents per gallon or \$30 per barrel, leading to a theoretical saving of $(\$30 \times 9.2 \text{ mmb/d}) = \276.0 million per day, assuming demand of 9.2 mmb/d. Over the same period, crude prices fell by \$25.48 per barrel, causing a theoretical loss to producers of $(\$25.48 \times 11.7 \text{ mmb/d}) = \298.2 million per day assuming production of 11.7 mmb/d. The net result is a loss of $(298.2 - 276.0) = \$22.2$ million per day over the period. In other words, the net impact of lower crude prices is greater than that of lower gasoline prices. In general, we expect that, over time, as long as crude production exceeds gasoline demand then the U.S. gains more from higher crude prices than it does from lower gasoline prices.

Longer Term

This analysis is simplistic because (we hear you saying) gasoline is not the only refined product affected by crude price increases. Prices for other refined products such as middle distillates including diesel and jet kerosene also increase as crude costs rise. And that is true, but prices for diesel and jet fuel tend to have an indirect impact on consumers over a longer period than gasoline. With use of diesel-type fuels for home heating significantly replaced by natural gas these days, diesel is now mostly used for rail and road freight transport. Higher jet fuel costs are typically absorbed by airlines over the short term and take longer to filter through to consumer ticket prices. So, the upside benefits of lower prices for middle distillate fuels are less immediate than for gasoline. There is certainly less direct political benefit from lowering distillate prices even though it undoubtedly provides longer-term positive economic impact. But if we consider the longer-term impact of lower distillate prices on the economy then we must also factor in the longer-term impacts of lower crude prices. The recent 33% drop in crude prices has an immediate revenue impact for producers. Over time the economic impact is far more significant in terms of the level of production — especially as crude prices fall close to break-even levels in the major shale basins. Crude prices dipping below \$50 per barrel last week is already testing the resolution of producers in higher-cost basins such as the Bakken and even threatens breakevens in the lower-cost Permian basin when combined with discounts for transportation congestion. If OPEC and its partners heed Trump's call to forgo production cuts at their Vienna meeting, we expect oil prices to continue their slide, barring other supply disruptions or more upbeat demand projections for 2019. The longer prices remain at or below \$50 per barrel, the greater the chance that U.S. shale producers will reduce new drilling. As we saw in 2015, such a retreat caused production to start falling within six months or so.

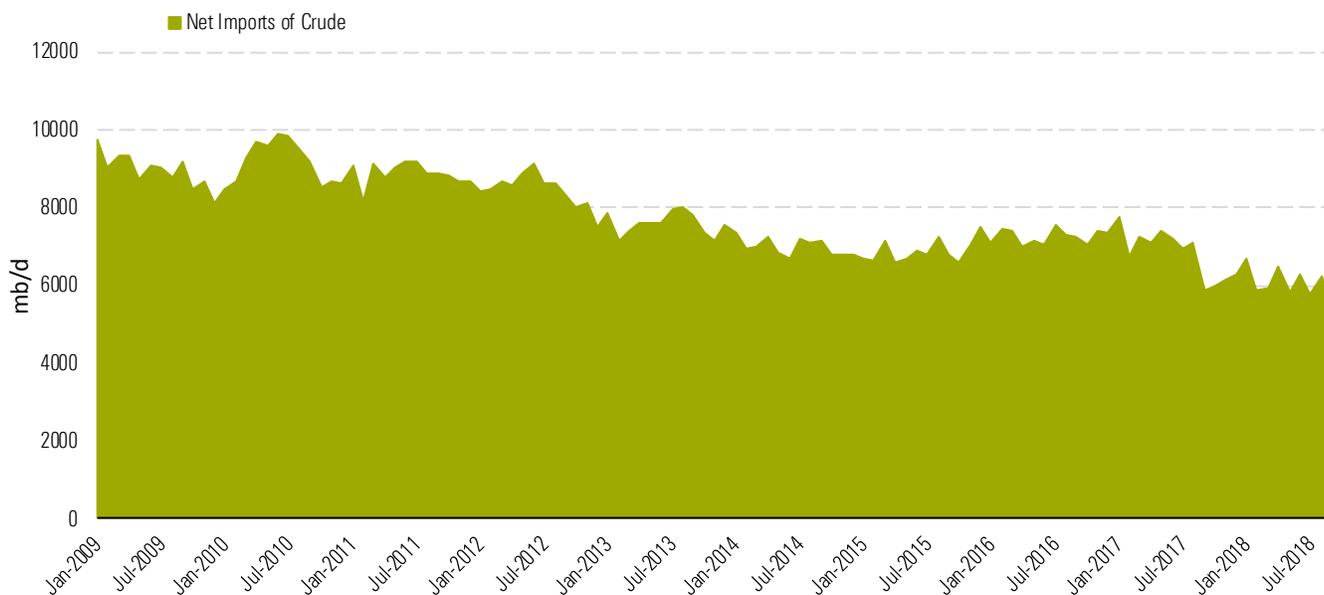
Economic Consequences

Falling crude production has direct economic consequences as witnessed after the price crash in 2015. Loss of producer revenue threatens the economic activity of larger producers and the solvency of smaller producers unable to meet debt obligations. Reduced drilling has a direct impact on employment and economic activity in the oil industry as well as a host of ancillary activities such as transportation and processing of associated gas liquids and natural gas. As production slows down, the need for new investment in gathering, processing and takeaway infrastructure evaporates. Since the start of the oil shale boom these industries have been major engines of economic growth in Texas, North Dakota, Oklahoma, Colorado and Wyoming.

Falling crude production also slows the path to energy independence often touted by the Trump Administration. The U.S. remains dependent on imports to meet total crude demand of around 17 mmb/d. As shale production increased in the past decade, that dependence has fallen. With unrestricted crude exports permitted since the end of 2015, the U.S. has exported increasing volumes of lighter shale crude even as we continue to import heavier grades that refiners prefer, but net imports have continued to fall. Exhibit 2 shows EIA monthly data for net imports of crude since January 2009. Crude imports averaged 9.0 mmb/d in 2009 falling to an average 6.8 mmb/d by 2017. This year, the data through September shows a further reduction to an average 6.1 mmb/d. If domestic crude production

slows down, then net imports increase again. That makes the U.S. more dependent on foreign crude and reduces the nation's clout in international markets as a major crude exporter.

Exhibit 2 U.S. Crude Imports



Source: Morningstar, EIA.

Conclusion

In conclusion, our analysis of the impact of lower crude prices in terms of consumer savings on gasoline versus the cost to U.S. producers shows that because crude production volumes are now higher than gasoline demand, the short-term net impact to the economy of lower crude prices is negative. Over the longer term, the picture gets complicated as lower prices for middle distillate products filter through the economy to provide a net positive impact. These benefits must be offset by the potentially huge economic impact of lower crude prices causing a slowdown in domestic production. We don't have the bandwidth for the in-depth analysis to prove this longer-term case but based on what happened in Texas and North Dakota after the 2015 price crash, we are confident the impact would be significant. As we have discussed previously, the OPEC and partners production agreement two years ago in November 2016 has provided significant benefit to the U.S. upstream oil industry by prompting new production and creating a home for crude exports (see our May 2018 piece "[U.S. Crude Exports Take Off](#)"). We believe the partners in that agreement are well aware of the demand-side risk of letting crude prices get too high. Arguably, high prices only became a concern this year once the U.S. imposed sanctions on Iran. The current administration's policy of rejecting any OPEC move to cut production is driven by short-term pursuit of headlines. The longer-term consequences for the U.S. oil industry of pushing Saudi Arabia to reject production restraint will be felt directly in states such as Texas and North Dakota. ■■

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