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Don’t Panic Over the Saudi Attack and the Oil Supply

OPEC would have had to cut output anyway, given the dramatic increase in American production.

By Donald L. Luskin and Michael Warren

The attack on Saudi Arabia’s oil infrastructure last weekend took out about half of the kingdom’s production capacity. Yet the market reaction was muted, with global oil prices rising only to where they were in May. Markets seem to recognize that Saudi Arabia and other members of the Organization of the Petroleum Exporting Countries will eventually need to curtail their oil production one way or the other to make room for the explosion of U.S. production. If they don’t, prices will collapse.

Daily U.S. crude-oil production has risen by 3.65 million barrels since the end of 2016, a leap of more than 40% in less than three years. The increase is mainly due to the revolution in hydraulic fracturing and horizontal drilling known as fracking. Global demand has grown by almost the same amount over that period, and the fracking boom has allowed the U.S. to fill all of it.

The only thing keeping global markets from falling into abject glut are offsetting production cuts by some of the world’s largest producers. Saudi Arabia has voluntarily cut production by 700,000 barrels a day as part of an OPEC quota system. U.S. sanctions have caused Iranian production to fall by 1.5 million barrels and Venezuelan production by 1.3 million. Considering the dollar values involved, this could be history’s largest shift of global market share for any product over such a short time.

And it’s only beginning. In the next several months, pipeline capacity in West Texas’ Permian Basin shale fields will expand by about one million barrels a day. That capacity will be taken up quickly by new production that had been held back only by lack of a way to get it to market. According to the Energy Department, drillers have sunk almost 4,000 Permian wells that are simply waiting to be fracked. In months, the Permian could be pumping enough to meet all of next year’s global demand growth—all from a single shale play.

Now suppose Venezuela restores order, Iran gives up its nuclear ambitions, and the U.S. lifts its sanctions against both countries. This would unlock another gusher of three million barrels a day and flood global markets. Oil prices would crash. While that would be a win for consumers at the pump, it could cause chaos in the U.S. oil patch. Crashing oil prices in late 2015 and early 2016 nearly broke the financial ecosystem of high-yield bonds, bank loans and leverage that enabled the initial flowering of the U.S. fracking industry. The U.S. barely avoided a recession then, as we wrote on this page at the time.

All of that happened because OPEC refused to support prices in hopes of driving U.S. frackers out of business. It didn’t work—and dealt a painful blow to OPEC’s oil-driven welfare states. It’s a mistake the cartel won’t make again.

President Trump has said the U.S. will release oil from the Strategic Petroleum Reserve to ease any shortages arising from the attacks on Saudi Arabia. By contrast, OPEC nations have said they would do nothing to increase production—effectively a temporary cut. When the cartel holds its regular meeting in Vienna in December, Saudi facilities will likely have been fully restored and OPEC will be forced to cut production the old-fashioned way.

With an initial public offering of Saudi Aramco in the works, the last thing Saudi Arabia wants is either an oil-price collapse or a war with Iran. So despite the outrage over the weekend’s attacks, the kingdom is unlikely to retaliate in any destabilizing way. In December it is likely again to bear most of the burden of production cuts to support prices.

Iran comes out a winner only in the sense that it will have mostly gotten away with a heinous terrorist act. The real winner will be the U.S., which can thank Riyadh for supporting prices at the same time as America takes the lead as the world’s largest and fastest-growing oil producer.

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