SCHLEGEL UND PARTNER
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Oily world

Causes of the recent oil price development and outlook

The price of Brent (Europe) and WTI (USA) crude oil has almost halved since July 2014. What was initially perceived as a sign of a weaker world economy now turns out to be a massive change on the supply side.

Global oversupply – and not a weakness in demand
Currently, the world crude oil market is in considerable oversupply. The drop in crude oil demand by around 1 M barrels per day during the first and second quarter of 2014 followed a seasonal pattern that recurs every year towards the end of the heating season in the northern hemisphere. In previous years, the crude oil supply decreased accordingly during this period of time. In the first half of 2014, however, the crude oil supply jumped by more than 1 M barrels per day to around 94 M barrels.

At first, the price effect was moderate, because the imbalance was expected to be of a transitory nature. As in previous years, crude oil demand inched up again to 93 M barrels in the third quarter. Against all expectations, however, the crude oil supply kept on going up, resulting in a persistent oversupply. Because the crude oil market is highly price inelastic – which means that demand increases only slightly following a price decrease – this resulted in a price slump.

Supply increase in the Americas
Since 2011, America's non-OPEC oil production increased at a CAGR of 8.2% to 19 M barrels per day, while demand remained constant (around 24 M barrels). Therefore, crude oil imports to the Americas decreased. The US has even managed to become a crude oil net exporter since 2013. This is a result of a higher production in Canada (oil sands), the US (shale oil), and Brazil (deep sea oil). Especially in the US, shale oil production increased considerably in recent years: it went up from 0.8 M barrels per day in 2011 to 3.4 M barrels per day in 2014.

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The EIA (US Energy Information Administration) expects that shale oil production in the US could reach 5 M barrel per day in 2020. However, the current crude oil price level will certainly leave its mark on developments, and it is questionable whether this production level could realistically be reached in five years' time.

Quarreling OPEC

In the past, the crude oil price has been supported by OPEC, which produces every third barrel of oil worldwide and which holds the most significant crude oil reserves (75%). Currently, however, OPEC is not united by a common interest, which weakens its power. Saudi Arabia, Kuwait, and Iraq are reported to be engaged in an oil price war, lowering their prices in order to maintain market shares in Asia, an export destination on which Russia has also set its sights. Saudi Arabia is also trying to defend its market share in the US, where the import of crude oil from Saudi Arabia decreased from 1.5 M to 0.9 M barrels per day between January and August 2014.

Significance of crude oil exports for public budgets

The public budgets of countries like Russia, Iran, Venezuela, and Libya are highly dependent on crude oil exports, which compels them to export as much as possible. This stands in contrast to countries like Saudi Arabia, which aims to maximize the long-term profits from crude oil production.

Outlook

The two most significant factors influencing further development of the crude oil supply this year are the reactions of the shale oil producers in the US and the OPEC supply. The break even point for hydraulic fracturing producers in the US is estimated at USD 50 to 70. It has been reported that more than 40 % of former oil wells in the US have ceased production since the plunge of the crude oil price. In addition, a considerable decrease in exploration and development of new oilfields can be observed. As a result, a stagnation of US crude oil production is predicted for the second half of 2015.

Concerning OPEC, no consensus on lowering of production is now expected at the next meeting in the summer. The message from Saudi Arabia that it can live with a price of USD 60 per barrel is all too clear. In addition, the lifting of Iran sanctions is likely to release a further 1 M barrels of oil on the world market.

No cuts in production are expected in other countries. Many future projects have been postponed – especially in the North Sea. However, this will have no short term effects.

Because of the persistently high supply level, the crude oil price could realistically remain between USD 50 to 60 until the end of this year. Schlegel und Partner still sees the maximum level at USD 80.

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The current crude oil price shock will certainly leave its mark on the market beyond this year. The lowering of exploration and development activities will have a rather medium term effect over subsequent years. In addition, investors will be more cautious with risky new projects. In particular, non-conventional production is not likely to increase as much as was previously expected.

Although the current low level of the crude oil price is also related to shale oil production in the US, we are far removed from a new paradigm on the global crude oil market caused by fracking. For this, the share of fracking oil from the US is too low in relation to the world production. Moreover, US non-conventional crude oil production is likely to peak within the next five years. Unlike the gas production sector, US oil fracking is not a game changer from a global perspective.

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