Global Oil Markets - Current Developments and Future Prospects

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Supply-demand imbalances have resulted in large stock builds; since the beginning of 2014, there has been a stock-build in almost every month.

Source: Energy Aspects, EIA, Reuters

It is excess supplies that puts downward pressure on the front end of the term structure causing the forward curve to shift to a contango to provide incentive for over-ground storage.
Stocks in the US and Europe Have Reached A Record High

**US Crude Oil Stocks, mb/d**

Stocks in the US has risen sharply as it is one of the few locations with available storage capacity.

**Total EU16 crude oil stocks, mb**

In Europe, stocks have reached a record level with limited room for further on-land storage.

Source: Energy Aspects
Builds are Mainly in Light Sweet Crude and in the US yet the WTI Time Spreads Tightening

The ‘glut’ is mainly in light sweet crude as most of the increase in US shale production is light and super light and refineries globally have become more complex.

Yet US crude prices remain relatively strong relative to Brent and WTI time spreads have shown signs of strength.

Source: Energy Aspects, EIA, Bloomberg
The Supply-Demand Imbalance and the Stock-Build
OPEC Feedback Mechanism Lost

In the absence of OPEC cuts (and supply disruption), the only mechanism to clear excess supplies is through supply and demand responses to price movements.

Saudi Arabia producing at above 10 mb/d with exports reaching record levels.

Source: Energy Aspects, MEES
Key Producers Increasing Output to Boost Revenues

Iraqi Oil Output, mb/d

Iraqi Monthly Revenues and Production

Iraq continues to ramp up production in an attempt to boost its revenues

But so far this has proved to be self-defeating with the increase in production being offset by lower prices

Source: Energy Aspects, Iraqi Ministry of Oil
Non-OPEC Supply Growth Concentrated in US and Canada

US Crude Output, y/y change, mb/d

Canadian Oil Production, y/y change, mb/d

US growth has been phenomenal with annual crude oil supply growth of 1.2 mb/d in 2014

In Canada, growth in production from oil sands offsets the declines from conventional fields

Source: Energy Aspects, EIA
US Shale Responds to Low Prices but no big Dent in Production Yet

**US Rig Count**

**US Crude Output and 12 month average, mb/d**

US shale supply has been responsive to lower prices as reflected in the sharp fall in the number of rigs and cuts in capex of US shale producers.

But production continues on its upward trend; the distribution of oil rig productivity is highly skewed with lower yielding rigs being shed first and remaining rigs being targeted towards productive ‘sweet’ spots.

Source: Energy Aspects, EIA
US Shale More Resilient than Originally Thought

US shale has proven to be more resilient than originally expected with efficiency improvements and lower costs of services reducing the break-even cost.

But declines rates are high and the expectation is that growth in production from new wells will not be able to offset the decline rates at one point.

Source: Energy Aspects, EIA
But US Shale is not only about Production Economics

For US shale, it is not only about production economics but also financial leverage as increase in US output has been associated with increase in total debt of US shale producers.

Despite negative free cash flows, financing has not yet proven to be disruptive force as US shale producers have been able to secure finance.

Source: Energy Aspects, Company Reports
US Shale Investors Continue to Raise Finance but at a High Cost

High yield energy bonds declined from their high levels but remains elevated

US shale producers managed to roll-over debt but this has come at a high cost

Source: Barclays, FT, Energy Aspects
In non-OPEC (ex-North America), record investment in the past few years reversed the annual declines in 2011 and 2012.

In 2014, Brazil was the main contributor to non-OPEC supply growth outside North America.

Source: Energy Aspects, EIA
Non-OPEC Supply Outside North America

Russian Oil Output, y/y change, mb/d

So has Colombian oil output despite the decline in the number of rigs

Source: Energy Aspects, EIA
Global Demand Growth Has Surprised on the Upside

Global Oil Demand, y/y change, mb/d

Asian Gasoline Demand, mb/d

Demand growth has been stronger than initially expected driven in part by cheaper prices and as a result the overhang in 2015 is likely to be less than the consensus.

With the light end of the barrel leading the growth in global demand.
In China, gasoline demand has outperformed that of diesel as the economy continues to rebalance from investment towards consumption.

So has gasoline demand in the US which has been rising as Americans are driving longer distances.

Source: Energy Aspects, China Customs, EIA
Against all Odds, Refining Margins Have Been Strong

Refining margins in Europe (against all odds) have been quite healthy due to cheap crude and higher gasoline prices encouraging runs.

So have refining margins in the US which are running at record level though margins have fallen below the 5-year average.

Source: Energy Aspects,
The Process of Clearance Also Matters
The Clearance of Backed WAF Barrels

With WAF barrels being pushed back from the US, the clearance is taking place mainly in Europe putting downward pressure on the Brent structure.

But if European refineries can’t clear the barrels, then the glut has to be shifted into the US or Asia; the time spreads will adjust to allow this arbitrage to work.

Source: Energy Aspects, Reuters
Clearing Barrels in Asia

Chinese demand for storage is a key dynamic in the market absorbing large part of the glut; the speed at which new storage facilities are brought on-line will impact how quickly the glut is cleared.

Asian refineries have more flexibility given the large investments in more complex refineries and hence choice is no longer confined to light sweet crude.

Source: Energy Aspects, Media Reports
Moving the Glut to the US and Impact on Differentials

**US Crude Imports of Nigerian Crude**

**Nigerian Differential to Dated Brent, $/Barrel**

The WTI-Brent arbitrage could allow some of the West African (WAF) crude to reach the US.

But eventually, the Brent structure and physical differentials will feel the greatest impact.

Source: Energy Aspects, EIA
Will OPEC Clear the Excess Supplies?
Saudi Arabia not Opposed to Cuts but Cuts Have to be Collective

From the supply side, Saudi Arabia is not willing to cut output unilaterally and it has been difficult to reach a consensus on a collective cut within OPEC.

Unlike 1998, reaching an agreement with non-OPEC producers to cut has not been successful so far.

Source: Energy Aspects, BP
In the absence of collective cut, Saudi Arabia is seeking market share and maintaining exports above a certain level.

Especially that competition in key markets has intensified as more and more exports are being directed to Asia.

Source: Energy Aspects, JODI
Competition not only confined to crude but also products

US Distillate exports, mb/d

Propane Exports, mb/d

US turns into world’s largest exporter of diesel as refineries in the US take advantage of the cheap crude and higher margins

LPG exports have also risen fast as US NGL production continues to increase and as export infrastructure is put in place

Source: Energy Aspects, EIA
Core GCC in Better Position to Withstand Lower Oil Prices

**Government Reserve Funds, Billion US$**

- **Iraq**
- **Kuwait**
- **Saudi Arabia**

**Saudi Government Debt (% of GDP)**

- **Public debt**
- **% of GDP, RHS**

Saudi Arabia (and other core GCC) has the financial resources to withstand a lower oil price environment though the drawing down of foreign reserves has been sharp.

Debt levels have been significantly reduced over the last decade but debt levels are expected to rise.

Source: Energy Aspects, JADWA
Revenue Objective Remains Key

**Oil & Gas Revenues, % of Gov’t Revenue**

- Kuwait
- Saudi Arabia
- Bahrain
- Oman
- UAE
- Qatar

**Saudi Arabia Budgeted versus actual spending**

- Actual spending
- Budgeted spending

But Saudi economy still relies heavily on oil revenues as attempts to diversify the economic have not been successful so far.

and government spending has been on the rise and therefore revenue objective would always feature high in oil policy.

*Source: Moody’s, JADWA*
Trade offs and Constantly Evolving Saudi Oil Policy

- Trade-off changes over time (depending on market conditions, nature of the shock, behavior of other producers)

- Pragmatic approach
  - 1986: Relevant trade-off in the circumstances of the time favored volume over price
  - 1998: favored price over volume (but agreement on cuts took months to reach)

- With advent of US shale, Saudi Arabia has entered unchartered territory; Still learning about a new source of supply and its responsiveness to price signals which made calculus of trade-off more uncertain
  - As Saudi Arabia learns more about this new source of supply, its policy will adapt accordingly

- Keeping market share at whatever cost is not an ‘ideological’ position and could change depending on market circumstances

Source: EIA
Increase in the number of rigs is mainly geared towards maintaining production at above 10 mb/d and not to add new productive capacity.

Saudi Arabia reduced flexibility in swinging production both on the upside and the downside due to a number of factors including the rapidly rising domestic demand.
Less Flexibility in Adjusting Production and Diminished Signalling Power

Fair price for oil is $75-$80 a barrel, says King Abdullah of Saudi Arabia

King Abdullah of Saudi Arabia said in remarks published on Tuesday that a fair price for oil was $75-$80 a barrel.

AFP
12:35PM BST 26 May 2009

Kingdom: $100 a barrel is fair price for oil

Al-Naimi says KSA willing to supply more oil in case of shortage

OPEC moots $80 as new ‘fair’ oil price - but will it stick?

Vienna, June 4 (By Alex Lawler, Rana El Gamal and Dmitry Zhiranov)

Integrating down the energy value chain to capture value added affecting supply and export decisions

Although Saudi Arabia’s policy is not constant, the signals are likely to be less effective in the future

Source: MEES
In absence of OPEC cuts, rely on investment and supply-demand responses to clear the glut
Disruptions within OPEC remain quite high, but the potential return of key suppliers (particularly Iran) continues to induce uncertainty in the market.

Disruption within non-OPEC remain at elevated level with production in countries such Syria, Yemen and South of Sudan coming to almost complete halt.

Source: EIA
### The Middle East-OPEC Investment Cycle

<table>
<thead>
<tr>
<th>Country</th>
<th>Oil capacity (mb/d)</th>
<th>Oil growth potential</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Saudi Arabia</td>
<td>12.5</td>
<td>High</td>
<td>Investment may be delayed by uncertainty over long-term demand for oil exports.</td>
</tr>
<tr>
<td>Iraq</td>
<td>3.3</td>
<td>High</td>
<td>Potential to more than double production, but security, bureaucratic and political hurdles likely to reduce growth.</td>
</tr>
<tr>
<td>Kuwait</td>
<td>2.8</td>
<td>Medium</td>
<td>Political uncertainty and restrictions on investment likely to contribute to missing target of 4 mb/d by 2020.</td>
</tr>
<tr>
<td>Iran</td>
<td>3.6</td>
<td>Medium</td>
<td>Nuclear deal and the lifting of sanctions needed to unlock growth. Technical issues may slow any increases.</td>
</tr>
<tr>
<td>Libya</td>
<td>1.6</td>
<td>Low</td>
<td>Significant reserves, but exploration and production will struggle until political stability and security returns.</td>
</tr>
<tr>
<td>Qatar</td>
<td>2.8</td>
<td>Low</td>
<td>Oil output growth prospects limited. Moratorium on gas projects, but debottlenecking may raise LNG exports.</td>
</tr>
<tr>
<td>Algeria</td>
<td>1.2</td>
<td>Low</td>
<td>Substantial decline rates in oil and gas fields; investment prospects remain limited; political stability fragile.</td>
</tr>
<tr>
<td>UAE</td>
<td>2.7</td>
<td>Low</td>
<td>Target of 3.5 mb/d production likely to be pushed from 2017 to 2020, limited supply growth prospects.</td>
</tr>
</tbody>
</table>

Within OPEC, increase in future productive capacity is rather limited with only few countries in a position to increase capacity.

Source: Energy Aspects,
Meeting Ambitious Targets Proving More Difficult

Kuwait has ambitious plans to increase capacity to 4 mb/d by 2020 but target unlikely to be met; weak business environment, volatile politics, mature fields, unattractive terms, and recently border disputes.

Iraqi production forecast revised downwards as over-ground problems continue to plague the oil sector.
Decline Rates Accelerating in Some Mature Areas

Algerian oil production, mb/d

Qatari oil production, mb/d

Algeria’s oil production falling fast and investment prospects remain limited to reverse declines

Qatari oil production falling fast with NGLs exceeding crude output

Source: Energy Aspects, MEES
The axe in Capex will Affect the project pipeline outside OPEC

Global Capex by region
$ million

<table>
<thead>
<tr>
<th>Region</th>
<th>2015E</th>
<th>2014A</th>
<th>2013</th>
<th>+ / -</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>122,426</td>
<td>154,295</td>
<td>142,234</td>
<td>(31,869)</td>
<td>(20.7%)</td>
</tr>
<tr>
<td>US Independents Intn.</td>
<td>15,458</td>
<td>22,731</td>
<td>22,842</td>
<td>(7,273)</td>
<td>(32.0%)</td>
</tr>
<tr>
<td>Canada</td>
<td>33,691</td>
<td>38,270</td>
<td>37,773</td>
<td>(4,579)</td>
<td>(12.0%)</td>
</tr>
<tr>
<td>Mexico</td>
<td>23,000</td>
<td>24,600</td>
<td>21,600</td>
<td>(1,600)</td>
<td>(6.5%)</td>
</tr>
<tr>
<td>Asia Pacific</td>
<td>102,676</td>
<td>118,219</td>
<td>116,286</td>
<td>(15,543)</td>
<td>(13.1%)</td>
</tr>
<tr>
<td>Majors International</td>
<td>104,271</td>
<td>112,724</td>
<td>112,400</td>
<td>(8,453)</td>
<td>(7.5%)</td>
</tr>
<tr>
<td>Russia/FSU</td>
<td>44,020</td>
<td>47,897</td>
<td>44,428</td>
<td>(3,877)</td>
<td>(8.1%)</td>
</tr>
<tr>
<td>Latin America</td>
<td>48,215</td>
<td>56,188</td>
<td>51,193</td>
<td>(7,973)</td>
<td>(14.2%)</td>
</tr>
<tr>
<td>Europe</td>
<td>41,542</td>
<td>48,416</td>
<td>41,728</td>
<td>(6,874)</td>
<td>(14.2%)</td>
</tr>
<tr>
<td>Middle East</td>
<td>40,565</td>
<td>40,745</td>
<td>35,790</td>
<td>(180)</td>
<td>(0.4%)</td>
</tr>
<tr>
<td>Africa</td>
<td>17,955</td>
<td>20,417</td>
<td>22,666</td>
<td>(2,462)</td>
<td>(12.1%)</td>
</tr>
<tr>
<td>Other</td>
<td>9,500</td>
<td>11,850</td>
<td>16,500</td>
<td>(2,350)</td>
<td>(19.8%)</td>
</tr>
<tr>
<td>International</td>
<td>408,744</td>
<td>456,456</td>
<td>440,991</td>
<td>(47,712)</td>
<td>(10.5%)</td>
</tr>
<tr>
<td>Global Capex</td>
<td>603,319</td>
<td>696,352</td>
<td>665,440</td>
<td>(93,033)</td>
<td>(13.4%)</td>
</tr>
</tbody>
</table>

Global Capex was around $700 billion in 2014, so a 13% decline would be nearly $100 billion. This will see projects, particularly deepwater and capital intensive ones, getting deferred and even cancelled, tightening future balances.

Source: Company data, Energy Aspects analysis
The Non-OPEC Investment Cycle Outside the US

Petrobras Production Forecast, mb/d

Some of the key growth centers such as Brazil are already feeling the pinch

Canada Production Forecast, mb/d

And Canada’s oil production has been revised downward substantially as many projects get postponed or cancelled

Source: Energy Aspects, Petrobras, Canadian Association of Petroleum Producers
The Non-OPEC Investment Cycle Outside the US: The Decline Rates

The decline rates in some of the mature areas such as the UK will accelerate in a low price environment.

While in Mexico large investments are needed to reverse the heavy declines.

Source: Energy Aspects, Petrobras, Canadian Association of Petroleum Producers
**US: The Short Investment Cycle**

**US Independents 2015 Capex**

<table>
<thead>
<tr>
<th>Basin</th>
<th>2014 Capex</th>
<th>2015E Capex</th>
<th>% chg.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Anadarko Global</td>
<td>9.2</td>
<td>6.8</td>
<td>(26)%</td>
</tr>
<tr>
<td>EOG Resources Eagle Ford / Permian</td>
<td>8.1</td>
<td>6.4</td>
<td>(21)%</td>
</tr>
<tr>
<td>Marathon Oil Corp Global</td>
<td>5.5</td>
<td>4.4</td>
<td>(20)%</td>
</tr>
<tr>
<td>Encana Corp Permian / Eagle Ford</td>
<td>2.6</td>
<td>2.8</td>
<td>10%</td>
</tr>
<tr>
<td>Continental Resources Bakken/SCOOP</td>
<td>4.6</td>
<td>2.7</td>
<td>(41)%</td>
</tr>
<tr>
<td>Concho Resources Permian</td>
<td>2.6</td>
<td>2.0</td>
<td>(23)%</td>
</tr>
<tr>
<td>Oasis Petroleum Bakken</td>
<td>1.4</td>
<td>0.8</td>
<td>(44)%</td>
</tr>
<tr>
<td>Halcon Resources Eagle Ford / TMS</td>
<td>1.4</td>
<td>0.8</td>
<td>(45)%</td>
</tr>
<tr>
<td>Rosetta Resources Permian / Eagle Ford</td>
<td>1.2</td>
<td>0.8</td>
<td>(38)%</td>
</tr>
<tr>
<td>Linn Energy California / E. Texas</td>
<td>1.6</td>
<td>0.7</td>
<td>(53)%</td>
</tr>
<tr>
<td>WPX Energy Williston / San Juan</td>
<td>1.4</td>
<td>0.7</td>
<td>(48)%</td>
</tr>
<tr>
<td>Sanchez Energy Eagle Ford</td>
<td>0.9</td>
<td>0.6</td>
<td>(28)%</td>
</tr>
<tr>
<td>PDC Energy Niobrara / Utica</td>
<td>0.6</td>
<td>0.6</td>
<td>(13)%</td>
</tr>
<tr>
<td>Denbury Resources USGC / Rockies</td>
<td>1.1</td>
<td>0.6</td>
<td>(50)%</td>
</tr>
<tr>
<td>Laredo Petroleum Permian</td>
<td>1.1</td>
<td>0.5</td>
<td>(52)%</td>
</tr>
<tr>
<td>Carrizo Oil &amp; Gas Eagle Ford / Niobrara</td>
<td>0.6</td>
<td>0.5</td>
<td>(26)%</td>
</tr>
<tr>
<td>Stone Energy GoM / Marcellus</td>
<td>0.9</td>
<td>0.5</td>
<td>(49)%</td>
</tr>
<tr>
<td>Diamondback Energy Permian</td>
<td>0.5</td>
<td>0.4</td>
<td>(4)%</td>
</tr>
<tr>
<td>Matador Resources Permian / Eagle Ford</td>
<td>0.6</td>
<td>0.4</td>
<td>(39)%</td>
</tr>
</tbody>
</table>

The US supply is still likely to respond the fastest, as cuts in capex translate into lower drilling and the impact of high decline rates dominates.

**Drilled but Unfracked Wells on the Rise**

But uncertainty about how quickly US production can come back if prices rise above a certain threshold.
The Issue of Spare Capacity

EIA estimate of OPEC Surplus Capacity, mb/d

In 1980s, spare capacity exceeded 10 mb/d; Oil system much bigger now, but estimated surplus capacity stands at less than 2 mb/d; under-ground vs over-ground storage matters

Source: EIA, BOFA Merrill Lynch Global Commodities Research

In an environment of high uncertainty, Saudi Arabia unlikely to increase productive capacity

Source: IEA, BofA Merrill Lynch Global Commodities Research
Conclusions (1)

- It is important to be clear about causality: it is supply and demand imbalances which cause stocks to rise and for the shape of the curve to switch to contango.
- High level of stocks will continue to put downward pressure on oil price and on time spreads; until stocks are drawn-down, price recovery will be capped.
- Pressure will be mostly felt on light crudes and the Brent structure given that the North Atlantic (ex-US) has become the clearing destination for light sweet cargoes.
- OPEC cuts remain most effective mechanism to clear excess supplies.
- Saudi policy is not constant and Saudi cuts should not be excluded but the bar to implement the cut has risen + less flexibility to adjust output + the power of signaling has reduced.
- Perception of the loss of supply feedback to clear markets affects market sentiment, increasing volatility and increasing the risk premium in investment in energy projects.
Conclusions (2)

- Clearing excess supplies through supply and demand adjustment to lower prices is subject to uncertainty and lags.
- So far demand growth has done most of the work, though it has not been strong enough to absorb all the glut.
- The supply response is yet to come but the supply has become more varied and the nature of the investment cycle has changed.
  - US shale: Short term investment cycle; production responsive to oil price; distinction between capex and opex difficult; financing issues; new business model.
  - GOM, non-OPEC outside the US: Long-term investment cycle; less responsive to prices; high capex, low opex; relatively high cost producers.
  - Middle East: Long term investment cycle; relatively low cost producer; less responsive to prices; constrained by non-economic barriers; downstream integration.
- The outcome of these combined investment cycles on output is yet to be seen.
- Key question: If non-OPEC outside the US falters and OPEC investment does not materialize, can US shale fill the potential gap?