Special Bulletin

A Japanese Perspective on the International Energy Landscape (231) August 4, 2015

Brent Falls below $50/bbl for the 1st Time in 6 Months

Ken Koyama, PhD
Chief Economist, Managing Director
The Institute of Energy Economics, Japan

On August 3, the benchmark Brent crude oil futures price dropped by $2.69 per barrel from the previous day to $49.52/bbl, slipping below $50/bbl for the first time in some six months, since January 29. The West Texas Intermediate crude futures price also fell by $1.95/bbl to a four-month low of $45.17/bbl.

Crude oil prices have gradually decreased since early July. The WTI price declined below $50/bbl on July 22 before the Brent price did so. Both crude oil prices hit lows below the $50/bbl early this year before rebounding on a fast decline in U.S. oil drilling operations, a relevant slowdown in shale oil production growth and a prediction of slack production in the future. From May to June, Brent rallied to a $65-67/bbl range and WTI to a $60-61/bbl range. From these levels, both Brent and WTI have dropped back to less than $50/bbl. What are the factors behind the latest fall?

First, it is important that the market still sees a substantial oversupply. The United States and other oil producing countries outside the Organization of the Petroleum Exporting Countries have slowed their oil production growth. But their production is still growing. OPEC has kept its output far above 31 million barrels per day. If the current conditions remain unchanged, the international oil market is expected to see a supply surplus of far more than 1 million bpd in the third and fourth quarters of this year. The current loose supply-demand balance is a basic factor behind the recent oil price fallback.

Second, price lowering factors have emerged one after another. On the demand side, the Greek debt problem and China's economic growth slowdown have retained downward pressure on the international oil market. The Greek debt problem has nominally calmed down as the European Union has decided to continue aid to Greece. But market fears are still lingering. When the Athens Stock Exchange resumed trading on August 3 for the first time in five weeks, stock prices plunged 16%, indicating that no optimism can be justified for the future. How the Greek problem would spill over to Europe or the whole of the world is still uncertain.

Under such situation, a fear of China's economic growth slowdown has been growing as noted in my previous special bulletin on "A Japanese Perspective on the International Energy Landscape." China is far more important for the world economy than Greece. Because of its great presence in oil and other commodities markets, the China factor exerts great influences on these markets. A preliminary Purchasing Manager Index announced by Chinese media group Gaixin in July declined from the previous month to 47.8, slipping below the boom-or-bust dividing line of 50 for the fifth straight month. The latest sign of China's economic growth slowdown might have stimulated selling in the crude oil market. In this way, the oil market has been reacting nervously to economic developments in China.

On the supply side, U.S. shale oil production's stronger-than-expected resistance to low oil prices has begun to affect market sentiments. As mentioned above, when crude oil prices bottomed out early this year, a perception that a rapid decline in U.S. oil drilling operations would affect U.S. shale oil production exerted some impact on the market. While oil drilling operations have declined substantially, U.S. oil output has continued moderate growth, as is well known. Oil drilling operations have almost stopped the decline, indicating a rebound. In response to the oil price decline, shale oil production costs have dropped substantially. A Platts report has indicated that the breakeven cost for North Dakota and other major shale oil production sites has declined to a $24-41/bbl range. While many higher-cost oil wells exist as a matter of course, shale production costs have generally dropped to enhance shale oil production's resistance to low oil prices. We must pay attention to the fact that shale oil's resistance to low oil prices is working to cap oil prices.

A new factor behind falling oil prices is Iran's expected comeback to the international oil market. Although the Iran nuclear agreement has been achieved to pave the way for Iran's comeback to the international oil market, Iranian crude oil supply in the market has not actually recovered its past loss under Western economic sanctions. Great uncertainties exist on whether, when and to what extent Iran would come back to the market. But the market might have begun to discount expectations of Iran's future crude oil supply expansion into prices. These multiple supply and demand factors have been combined to drive down oil prices.

In addition to these supply and demand factors, we see financial factors affecting oil prices. Among financial factors are the dollar's appreciation, expected U.S. interest rate hikes and the risk-off trend accompanying the Shanghai stock market fall. Generally, supply/demand and financial factors have been coupled to produce synergistic effects to drive down oil prices. At present, there is no sign that these factors will change greatly. Therefore, the oil market is likely to remain weak in the immediate future. Particularly, oil prices could decline further depending on developments regarding the Chinese economy and the Greek debt problem.

If Iran's comeback to the international oil market grows likelier with oil prices remaining weak toward the end of this year, downward pressure on oil prices may increase further. Depending on supply and demand conditions, possible discussions at the next OPEC meeting based on future market developments will emerge as a focus of attention.

Contact: report@tky.ieej.or.jp

The back issues are available at the following URL

http://eneken.ieej.or.jp/en/special_bulletin.html