Special Bulletin

A Japanese Perspective on the International Energy Landscape (234) August 28, 2015

# Behind the recent Double-Dip Decline in Crude Oil Prices and International Oil Market

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

I visited Washington DC and New York from August 24 through 27, to have discussion on the issues related to crude oil prices and international oil market with U.S. government officials, oil industry people and think tank researchers at various meetings.

Just amid these meetings, crude oil prices declined rapidly. As fears about the future Chinese economy shook the world in response to a new plunge on the Shanghai stock market, a global stock market fall emerged. Under such situation, crude oil prices nose-dived. The benchmark West Texas Intermediate crude oil futures price sank to this year's new low of $38.24 per barrel on August 24, slipping below the psychologically important barrier of $40/bbl. It thus experienced a double-dip decline after rallying from the low seen early this year.

As a matter of course, the discussions focused on how to analyze the double-dip decline and what crude oil prices would be like in the future. My discussions with many American experts indicated many issues. In the following, I would like to sum up issues I view as essential and important.

First, the experts agreed that while serious fears about the Chinese economy have shaken the psychology of market players and led to the double-dip decline by prompting selling to feed on itself, substantial oil oversupply has been behind the weak oil prices. They also shared the view that it would be difficult to resolve the oversupply in the short term for the reasons explained below.

Interesting arguments were seen on global oil demand among multiple factors behind the oversupply. The International Energy Agency and other analyses forecast that global oil demand will increase by 1.6 million barrels per day from the previous year in 2015 and by 1.4 million bpd in 2016 partly thanks to low crude oil prices. But a dominant view seen at my discussions with the American experts was that real global oil demand or actual consumption would not be as strong as indicated by the forecast. They pointed out that a substantial oil inventory increase symbolizing the loosening supply-demand balance indicates the present demand as including oil for expanding inventories and reserves. They also interpreted economic realities as indicating that oil consumption in major countries other than the United States might not have grown so much. Therefore, any great fears about the future Chinese economy lead to speculation that consumption would decline further, accelerating the loosening of the supply-demand balance.

As for oil supply, many of the experts agreed that oil output in non-OPEC oil producing countries has decelerated steady growth that had continued until 2014 and would make the deceleration clearer due to the latest dip. An interesting view given in the discussions was that if crude oil prices slip below $40/bbl and fall further, high-cost oil production may have a greater chance to be lost. Those that would be the most vulnerable to the dip are a large number of stripper wells producing only 10 barrels per day each in the United States, some of the experts noted. Given their very small sizes, low efficiency and production characteristics, these wells, if once shut down due to low prices, would be difficult to restart production, they pointed out, calling attention to their possible loss. These small wells' total output is estimated at several hundreds of thousands of barrels per day. The estimate is not necessarily small. Interestingly, some of the American experts called for paying attention to this point in analyzing non-OPEC production depending on future price changes.

Meanwhile, an impressive argument heard frequently at the discussions was that shale oil production has enhanced its resilience to low oil prices. Some of the American experts noted that the U.S. oil industry, including many oil and gas companies undertaking shale oil and gas production, has been striving to cut costs in response to low prices. They pointed out that industry-wide efficiency improvement efforts and actual falls in overall resources and raw materials prices as well as the oil price plunge have led costs to be cut more than expected. As a matter of course, shale oil production has resisted low oil prices since early this year far more than expected as finance has continued for shale oil producing companies. Whether such finance would continue in the future is uncertain. Given this and other problems, U.S. oil production growth may inevitably slow down if oil prices remain low. Nevertheless, many of the American experts in discussions with me noted that overall U.S. oil production, including shale oil output, has generally enhanced its resilience and flexibility to low oil prices as the oil price plunge has led to production cost cuts and improved responses of individual firms and the entire industry. Some pointed out that U.S. oil production may continue expanding over a long time although growth may decelerate in the immediate future.

I heard various views about how the Organization of the Petroleum Exporting Countries would respond to the oil supply and demand environment. A common view was that OPEC including Saudi Arabia has indicated no sign of any revision to its oil production policy even in the face of the double-dip decline in oil prices. As for Iranian crude oil's comeback to the international oil market, which could come upon Western countries' possible termination of Iran sanctions and make the oil oversupply even greater, many of the American experts forecast that Saudi Arabia and other OPEC countries may still try to maintain their market shares, triggering another price-cutting race. In this respect, what could bring about Saudi Arabian or OPEC policy changes has emerged as a matter of concern to many oil market players. Given that some development regarding the Iran sanctions is expected to come late this year, some of the American experts noted that what OPEC would discuss and decide at its next general meeting would be important and worthy of close attention. This notion was interesting.

The global stock market fall came to a pause as the Shanghai market decline ran its course, with U.S. gross domestic product data indicating the firmness of the U.S. economy. In response, crude oil

prices rose back above $40/bbl on the 27th. As far as the great oversupply remains unchanged, however, no optimism can be warranted for the future. Many of the American experts in the discussions noted that crude oil prices could come under downward pressure again depending on future developments and that how far oil prices could decline in such case would be uncertain. We may have to closely watch the fast-changing international oil market and crude oil prices.

Contact: report@tky.ieej.or.jp
The back issues are available at the following URL
http://eneken.ieej.or.jp/en/special_bulletin.html