Special Bulletin
A Japanese Perspective on the International Energy Landscape (326)

June 2, 2017

WTI Futures Averaged $51/bbl in January-May, Staying between $50-55/bbl in Majority of Trading Days

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

From January through May, daily closing levels of the front-month West Texas Intermediate crude oil futures contract averaged $50.97 per barrel, ranging from the lowest at $45.52/bbl (on May 4) to the highest at $54.45/bbl (on February 23). On more than 60% of the 103 trading days in the period, the benchmark crude oil futures price moved roughly within a $50-55/bbl range. Since late April, however, it stood at levels below $50/bbl. Meanwhile, daily closing levels of the front-month Brent futures contract averaged $53.75/bbl and ranged from $48.38/bbl to $57.10/bbl in the period, moving primarily in the $50-55/bbl range as well.

Factors behind the benchmark WTI futures price's recent slip below $50/bbl are discussed later. The five-month period featured specific factors for the ceiling and floor of the range. Supporting the floor has been a coordinated oil production cut agreed finally at a general meeting of the Organization of the Petroleum Exporting Countries in November 2016 following the discussion among the oil producers to cut production from the middle of the year. The coordinated production cut, in which Russia and other non-OPEC oil producing countries agreed to participate, totaled about 1.8 million barrels per day, including 1.2 million bpd for OPEC. Since January when the coordinated production cut started, OPEC's rate of compliance with the production cut has remained close to 100%.

While country-by-country rates of compliance with the production cut were patchy, OPEC leader Saudi Arabia implemented a substantial cut to achieve the high compliance rate for the whole of OPEC. The market has appreciated the high compliance rate as indicating the seriousness of OPEC and its leader Saudi Arabia about the production control. This has been a major factor supporting the floor of the oil price range.

Meanwhile, there have been two factors to cap oil prices at the ceiling. The first factor is oversupply symbolized by high inventory levels. The coordinated production cut has been officially aimed at restoring a normal inventory level. In the actual market, however, inventory reduction has failed to make progress. Inventories have remained at historically high levels, in particular in private sector inventories at more than 3 billion barrels in the member countries of the Organization for Economic Cooperation and Development. Market participants may apparently share the recognition that the high inventory levels have capped crude oil prices.

The second factor is the expansion of supply including rising U.S. shale oil production. When crude oil prices began to plunge in 2014, Saudi Arabia adopted a policy of leaving the market to decide crude oil price without cutting production to defend oil prices. Then, Saudi Arabia might have expected that U.S. shale and other high-cost crude oil would exit from the market as prices decline. Actually, U.S. crude oil production including shale oil declined in 2016 in response to the rapid crude oil price plunge. At the same time, however, U.S. shale oil producers thoroughly streamlined or rationalized their operations to lower their production costs. The average shale oil production costs have declined to around $40/bbl, according to the International Energy Agency. Market participants have increasingly conceived that shale oil producers can maintain or moderately expand production even at the present crude oil price levels and could promptly expand production in response to further price hikes. In fact, U.S. crude oil production increased by more than 800,000 bpd from October to the present. The production expansion has worked to cap crude oil prices at the ceiling.

In this way, crude oil prices have roughly remained in a boxed range between $50/bbl at the floor and $55/bbl at the ceiling. However, market conditions can always change to lower prices below the floor or push up them above the ceiling. At present, market forces are lowering crude oil prices below the floor. Market participants now conceive that market sentiment is not necessarily strong at present. The high crude oil inventories and the shale oil production expansion have gradually enhanced downward pressure on crude oil prices. The pressure has shaken OPEC and other oil producing countries since late April, forcing them to agonize over whether to extend the coordinated production cut planned for six months from the beginning of this year and whether to change the cut upon the extension.

In response to the market pressure, OPEC eventually decided to extend the coordinated production cut for nine months at its 172nd general meeting on May 25. If OPEC failed to extend the production cut, crude oil prices could have plunged. To avoid the worst development, OPEC had no choice but to extend the production cut. The extension had been well expected earlier. In this sense, the latest OPEC decision included no surprise. The crude oil price trend after the decision indicates that the market has not been satisfied with the decision that failed to expand the production cut while extending it for nine months.

On the other hand, OPEC might have adopted a time-buying strategy by extending the production cut in a bid to wait and see future developments. While global oil demand indicates a steady increase of 1.3 million bpd, a shale oil production expansion is countered by a stagnation or decline in other non-OPEC production. In such circumstances, OPEC may expect that the market will gradually go in the direction of rebalancing if it continues to control production through the coordinated production cut. It may not be strange for oil producing countries to have chosen to buy time with the extension of the coordinated production cut until rebalancing becomes clearer.

Through the second half of this year, whether crude oil prices will remain in a boxed range and what level the ceiling or floor of the range will be will attract much attention. As noted above, market conditions can always change. While the shale oil production trend and oil producing countries’ coordinated production cut as described above are expected to remain key factors, there are many other attention-attracting factors including the world economy and oil demand trends, geopolitical risks and their effects on oil supply. Given that crude oil prices are likely to make various new developments, with new pressure emerging, in response to market changes, we will have to keep close watch on the future trend.

Contact: report@tky.ieej.or.jp

The back issues are available at the following URL

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