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Short to Medium-term Oil Supply Perspective

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From November 16 through 20, I visited the United Kingdom to have opportunities for discussions with energy experts and industry people, including a workshop sponsored by the Oxford Institute for Energy Studies. Among the various topics in the discussions was a short to medium-term international oil market prospect seen particularly from the supply side. Here, I would like to summarize impressive points of the discussions.

The grand assumption for the discussions was that the present international oil market is gradually going in the direction of rebalancing, with inventories being reduced gradually. As a matter of course, most experts and oil market participants think that the inventory reduction toward a supply-demand equilibrium has taken far more time than expected and has remained very slow. The largest factor behind such situation is that U.S. shale oil production has increased its resistance to lower oil prices and can increase even at present price levels.

Therefore, the discussions naturally focused on a U.S. shale oil production prospects for next year and beyond. The discussions covered various angles including present and projected productivity improvement at various shale oil production regions and challenges involving shale oil producers' investment, production behaviors and fundraising operations. However, a dominant view was that shale oil production would increase at an annual rate of around one million barrels per day in 2018 and 2019 as the breakeven cost declines amid ongoing progress in productivity improvement. Later, shale oil production is expected to increase further, though more slowly, through the early 2020s. Particularly, shale oil production growth will work to restrict crude oil price hikes in 2018 and 2019.

In the discussions, however, a participant presented a view that as global oil demand continues steady growth over a medium term, oil supply from projects subject to past final investment decisions, even including growing shale oil supply, may fail to meet demand in aggregate term, causing a possible large supply-demand gap or supply shortages in the future. If many market participants share the prospect of a supply-demand gap emerging over a medium term, oil companies may change their decisions and investment behaviors and implement investment required to prevent the supply-demand gap, according to another view presented in the discussions. However, another school of thoughts was that oil companies have maintained their cautious attitude on investment and are unlikely to expand capital spending at least at the present oil price levels, even if a supply-demand gap is expected to come over a medium term.

If a supply-demand gap emerges over a medium term, possible future scenarios are that oil prices may post a transition in the form of a moderate, smooth increase or a rapid spike, depending on oil companies' investment decisions and supply expansion to fill the gap. We must take note of the fact that such price change originates from a supply-demand balance change and differs from a spike caused by geopolitical risks or supply disruptions.

Arguments about oil policy options for the Organization of the Petroleum Exporting Countries, particularly its leader Saudi Arabia, were interesting as well. As for an OPEC meeting planned for late November, discussion participants roughly shared a view that OPEC and non-OPEC oil producing countries including Russia would agree to extend their coordinated production cut. As for policy options for Saudi Arabia, a discussion participant argued that the kingdom might (1) extend the coordinated production cut while seeking participating countries' better compliance with production quotas, (2) return to the market share strategy with the compliance lost, or (3) serve as a swing producer to adjust supply and demand. But each option would not be easy for Saudi Arabia to adopt.

As oil inventories have decreased gradually since late October, the key Brent crude oil futures price has risen back above $60 per barrel with market players being conscious of geopolitical risks, allowing OPEC to take a breath. However, no optimism can be warranted for OPEC. Crude oil price hikes could encourage U.S. shale oil production to increase and could weaken coordinated production cut participants' compliance with production quotas. OPEC could thus be plagued with difficult problems. If current price levels cannot encourage oil companies to substantially expand investment as noted above, the situation may remain unchanged, leading to a widening supply-demand gap in the future. Then, the oil market could grow more volatile instead of posting any smooth transition.

Too low crude oil prices are a big problem for most oil producing countries including Saudi Arabia from various viewpoints including balanced budgets. However, too high crude oil prices could affect future oil demand growth, becoming a significant problem particularly for Saudi Arabia. At a time when the potential rapid spread of electric and other advanced vehicles attracts attention, too high crude oil prices cannot be expected to bring about favorable results for Saudi Arabia. In a bid to maintain its market stabilization power, Saudi Arabia could implement investment to expand oil production capacity to keep or secure surplus capacity, according to some discussion participants.

Apart from oil market supply and demand analyses, interesting arguments about growing Middle Eastern geopolitical risks were made in the discussions. So far, high geopolitical risks in the Middle East have basically coexisted with lower crude oil prices. Over the past several weeks, however, crude oil prices have reacted to the Kurdish problem in Iraq and the reported arrest and detention of numerous royal family and cabinet members in Saudi Arabia. While how these geopolitical risks would develop in the future remained uncertain, discussion participants made arguments about the possibility of these risks deteriorating to directly affect oil supply. In such event, geopolitical risks could lead to a crude oil price spike. Then, efforts to shift away from oil could globally expand and accelerate, leading oil demand to peak.

Oil crises in the 1970s drove strong oil substitution policies in member countries of the Organization for Economic Cooperation and Development, while decelerating the world economy. As a result, global oil demand decreased in the early 1980s. If a significant event emerges on the supply side from now on, a similar policy drive may come in the entire world including non-OECD countries that have been expected to lead global oil demand growth in the future. Oil supply stability and the future course of oil supply are key factors that could move the world.

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