WTI Rises Close to $70/bbl for 1st Time since November 2014

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

On May 4, the front-month West Texas Intermediate crude oil futures contract closed at $69.72 per barrel on the New York Mercantile Exchange, up $1.29/bbl from the previous day. It rose for the third straight day, posting an intraday high of $69.97/bbl, close to the psychological barrier of $70/bbl. The WTI futures last traded above $70/bbl in late November 2014. If the price rises above the barrier, it would be the first time in 42 months. On the same day, the front-month Brent futures also gained $1.25/bbl to $74.87/bbl. It was pointed out that the WTI’s rise close to $70/bbl came as buying outpaced selling on market participants’ growing consciousness of geopolitical risks amid increasing tensions over the Iran nuclear agreement. In a manner to support the crude oil futures hike, the Dow Jones industrial average on the New York Stock Exchange soared by 332 points or 1.4% from the previous day to 24,263 on the U.S. unemployment rate’s fall to an 18-year low and famed investor Warren Buffet’s reported plan to acquire additional Apple shares.

So far this year, crude oil futures prices increased substantially from the 2017 averages of $50.9/bbl for WTI and $54.7/bbl for Brent. In January, Brent rose back above $70/bbl for the first time in 37 months. Since April 10, Brent has remained above $70/bbl and WTI has stayed above $65/bbl. The averages for January-April came to $68.4/bbl for Brent and $63.8/bbl for WTI, posting a substantial increase of $12-13/bbl or more than 20% from a year earlier. In this sense, the international oil market and crude oil prices may be entering a new phase.

Certainly, geopolitical risks have been combined with robust economic growth and a risk-on market to boost crude oil prices. While these direct factors are important, changes in supply and demand fundamentals are even more important. The current crude oil price uptrend started in October 2017. Since then, the market has grown responsive to geopolitical risks in the Middle East, leading crude oil prices to creep up. While the Organization of the Petroleum Exporting Countries, Russia and other non-OPEC oil producing countries have continued their coordinated production cut since the beginning of 2017, private sector oil inventories in the world (or the Organization for Economic Cooperation and Development) have sustained a decline to gradually reduce excess inventories. When inventories remained excessive, the market was not responsive to geopolitical risks. As inventories have declined close to the normal level, however, the market has grown responsive to geopolitical risks.

As crude oil prices have risen close to $70/bbl this year, whether the rise is a temporary one depending on geopolitical risks has attracted global attention. Then, the potential acceleration of U.S. shale oil production expansion has become a key issue. U.S. shale oil features a short investment-production cycle and production costs have fallen thanks to the industry’s cost-cutting efforts in the low oil price period. As investment and production at the current price levels can be expected to result in sufficient profits, U.S. shale oil production is now forecast to increase substantially this year. The International Energy Agency has predicted that shale oil production...
expansion would lead U.S. oil production this year to post an increase of 1.52 million barrels per day from 2017, the largest since a historic rise in 2015. The predicted U.S. oil output expansion alone would amount to a global oil demand increase of 1.47 million bpd. U.S. oil production growth alone would thus cover a global demand rise. Given the potential acceleration of U.S. shale oil production expansion toward the second half of this year, the U.S. oil production growth is expected to restrict crude oil price hikes.

U.S. shale oil production expansion is certain to impose a grave impact on the global oil supply-demand balance. In analyzing the recent price hike, however, we must reconsider the whole picture of the entire supply including U.S. shale oil and of the market. As noted above, global oil demand in 2018 is rising robustly for the second straight year, driven by demand growth in Asian developing countries such as China and India. On the supply side, non-OPEC oil production this year is expected to rise by 1.79 million bpd from the previous year, according to the IEA. Supply growth is thus expected to surpass demand growth. This means that non-OPEC oil production growth alone could cover demand growth. The United States is predicted to expand oil production by 1.52 million bpd, Canada by 250,000 bpd and Brazil by 100,000 bpd. The three countries’ oil production expansion thus totals 1.87 million bpd against the forecast global production growth of 1.79 million bpd, meaning that non-OPEC oil producing countries other than the three would reduce their output even amid crude oil price hikes. Conversely, the supply-demand balance could be very tight without the substantial U.S. production expansion.

While production in most non-OPEC oil producing countries other than the United States is stagnant, some non-OPEC oil producing countries are attracting global attention with substantial production drops. Among them is Mexico. After maintaining production levels around 3 million bpd around 2010, Mexico has rapidly reduced production since 2015 due to the maturation and depletion of oil fields and investment shortages. Mexican oil production fell to 2.23 million bpd in 2017 and is expected to decrease by 150,000 bpd from 2017 to 2.08 million bpd this year. Mexico has attempted to stop a production decline and increase production by opening the upstream sector to investment. For the immediate future, however, the attempt would be difficult to carry out successfully. Some experts say that Mexican oil production fell to 2.09 million bpd in March and is likely to accelerate a fall to slip below 2 million bpd. The production drop in such a major oil producing country has exerted influence on the supply-demand balance, attracting attention from oil market participants.

Even more significant is the influence of OPEC member Venezuela that has accelerated an oil production decline like Mexico. Due to economic and social unrest, Venezuelan oil production decreased rapidly to 1.49 million bpd in March from 2.10 million bpd in December 2016 before the coordinated production cut by OPEC and some non-OPEC oil producing countries. As Venezuelan oil production is predicted to fall further amid social and economic deterioration, market participants are sensitive to the Venezuelan situation. The decline in Venezuelan production has led to a drop in overall OPEC production. In March, the 14 OPEC members’ oil output totaled 31.83 million bpd, slipping below the oil cartel’s production target of 32.50 million bpd. While the current OPEC production cut features many OPEC members’ strict compliance with their respective production quotas, the substantial fall in Venezuelan output has made an unignorable contribution to the overall OPEC oil production decline. If the latest OPEC production level of 31.83 million bpd is maintained, demand would exceed supply in 2018 as in 2017, resulting in a further decrease in inventories.

Market players have gradually recognized such situation and grown responsive to geopolitical risks including the Iran problem. In this sense, they will closely watch U.S. President
Donald Trump’s decision on the Iran nuclear agreement on May 12. If the United States withdraws from the nuclear agreement, crude oil prices could rise further on concern about the decision’s impact on Iranian oil exports. As a matter of course, the current oil market also faces downside factors including the escalating U.S.-China trade dispute’s adverse impact on the world economy and the potential acceleration of U.S. shale oil production expansion. The market situation could change depending on how these uncertain factors will work. We will have to keep close watch both on geopolitical risks and major oil producing countries’ production trends.

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