Oil: Changing tides

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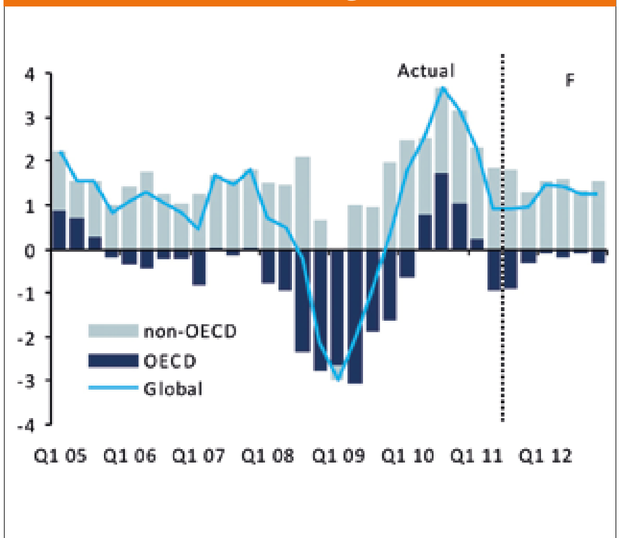
An increasing loss in confidence in global policymakers to deal with the sovereign debt situation, along with worries of global growth, have thrown oil markets into disarray. The recent worsening in conditions has led to a widespread and severe downwards lurch in risk appetite. Oil, like most markets, seems to be trading in a maelstrom of information, where any headline is immediately subjected to opposite and contradictory interpretations, with unpredictable consequences for prices. Indeed, much of the immediate action in oil is simply based on the same climate of economic fear that is battering equities.

For many, the key question is whether this is a repeat of the 2008-09 cycle, and what is the downside to prices. Despite the gloomy picture concerning sovereign debt in both Europe and the US, the corporate bond markets are functioning normally and most forms of credit remain broadly inexpensive – a key difference from 2008. Second, the backdrop of the oil market is significantly different from 2008. The supply side of the market is performing far more poorly now than three years ago. Libya still remains out of the market, with the cumulative loss of Libyan barrels now moving close to 350m barrels, and declarations of force majeure have reduced Nigerian supplies while oil embargoes are set to stymie Syrian exports. Moreover, the unrest in North Africa and the Middle East is leading to higher break even price requirements to balance vastly higher spending programmes in most of the Gulf countries. Thus, the threshold for active producer involvement in the market is some US$20 -25 higher, lending support to an oil price at around US$90-100 per barrel. Finally, the structure of the demand composition of the oil market is significantly different now than it was in 2008. In 2008, global oil demand was contracting, with the burden of OECD demand declines a large 1.7 million barrels a day (mb/d). So far, despite the revisions to current and projected US oil demand, the scale of decline in the OECD is a far more modest 0.5 mb/d.

Global oil demand growth, mb/d



Source: Barclays Capital

But it is really the scale and speed of non-OECD demand increases that makes a significant difference to the global picture. The share of non-OECD demand has risen from about 44 per cent in 2008 to 48 per cent this year, and is en route to almost 50 per cent by next year. Within that, China's share of global oil demand has increased by more than 2 per cent. In fact, Chinese oil demand growth averaged around 0.4 mb/d across 2008-09, half the level of growth seen across 2010-11. Thus, China and emerging markets are in general far more important for the oil demand trajectory, and while measures to tackle high inflation have undoubtedly tempered the growth profile in the short term, structural factors should keep economic and oil growth at elevated levels in these countries.

Perhaps most importantly, the main reason why we do not expect a repeat of the 2008-09 oil price cycle, short of a macroeconomic discontinuity, is what that cycle told us about the structure of the oil industry. Below US$90, investment dried up and was frozen; below US$70, the industry was visibly struggling, with unconventional oil – increasingly the marginal supply on the non-OPEC front – the worst affected. On the demand side, lower prices fed into a sharp global demand upswing, leading to the fastest demand growth for 30 years, with it running at least twice as fast in 2010, and perhaps three times as fast, as the maximum the supply side could cope with in the medium term. Spare capacity of 6.5 mb/d quickly became spare capacity of just 2.5 mb/d. The lesson of the last cycle is that the further prices are forced below US$90 and the longer they stay there, the faster the market tightens in the upswing.

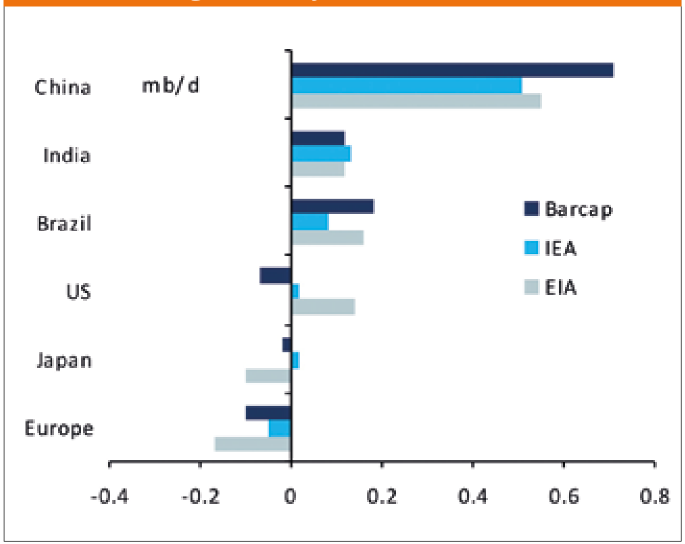
Over the next five years, a steady annual growth rate corrected for distortionary base effects of 1.3-1.5 mb/d appears to us to be the status quo, short of a major macroeconomic discontinuity, and non-OECD countries are set to provide the bulk of that growth. Within that solidity, the main components of growth are those that have become the regular ones in recent years (i.e. China, India, Saudi Arabia and Brazil). Indeed, it appears 2012 will be no different. We project oil demand growth of 1.31 mb/d in 2012, marginally higher than the current 1.13 mb/d forecast for 2011, with the absolute level of demand averaging 90.2 mb/d, a record high and the first time global oil demand would achieve an annual average of above 90 mb/d. The oil demand profile is likely to continue to be dominated by non-OECD demand growth, which we expect to be 1.57 mb/d.

OECD demand, not surprisingly, is expected to slip back into negative territory this year and follow through next year, on the back of increased energy efficiency and oil demand suppression policies together with significantly higher price averages compared to the past decades. However, structural trends tend to dominate the profile of non-OECD demand growth, which now constitutes a far larger share of global oil demand and all of global oil demand growth. In fact, straight after the financial crisis of 2008-09, the sheer scale of non-OECD demand growth resulted in global oil demand surpassing 2007's peaks by 1.7 mb/d last year, a good five to seven years earlier than consensus expectations. Indeed, in 2013, we expect non-OECD demand to overtake OECD demand in absolute levels for the first time. The marginal consumer in the oil market is increasingly showing reduced sensitivities to higher prices, evident in the robust growth in global oil demand even in the face of US$100+ average prices. At these price levels, it is not surprising that OECD oil demand is running lower, year on year, by over 200,000 b/d in the year-to-date, with elements of destocking having magnified the extent of that fall somewhat.

However, the fact that global oil demand is still running higher, year on year, by 7 mb/d underlines the shift in the marginal barrel of oil demand. While the blame for inflation, tighter policy response and patchier economic growth has often been laid at the door of high oil prices, the fact remains that we expect global economic growth to average a solid 3.8 per cent this year and 3.9 per cent next year (alongside an annual increase in oil prices of 39 per cent and 3 per cent, respectively). Have higher oil prices tempered economic growth in some parts of the world? Yes, we think they have. But have they been the sole factor for the recent softness in the macroeconomic data? No, they have not, with factors such as the earthquake in Japan, a patchier recovery in manufacturing and food inflation playing a hugely important part. While the jury is still out on this debate, in our view, given the bias of inelastic non-OECD demand in the global profile, the world can sustain a US$100 average oil price without necessarily suffering from negative economic growth in the short term. The juxtaposition of triple-digit oil prices and 3-5 per cent economic growth is likely to remain a debate that continues in policy circles through 2012.

The supply side of the market is performing far more poorly now than three years ago. We remain doubtful about the speedy re-incorporation of Libyan oil into the world market. The first task of a new Libyan government will be to repair the damage caused to the oilfields and other oil installations by a lack of investment funds, imported spare parts, and equipment and insufficient maintenance. The second task will be to negotiate with foreign oil companies the terms of production-sharing agreements for investments and operations in new and old oilfields. The new government will be in dire need of revenues and will not be in a position to give money away to foreign investors unnecessarily in our view. The problems of Libya will not necessarily be solved by the departure of Gaddafi; indeed, that might just be the start of some long-lived difficulties. The resumption of 250-500,000 b/d of production seems possible by year-end and into the first quarter of 2012, in our view, but extrapolating from this to the early restoration of full output volume of 1.7 mb/d from Libya would be a mistake.

Annual changes in key demand centres in 2012



Source: IEA, EIA, Barclays Capital

→ Non-OPEC supply growth, too, seems to have entered a turning point, after the upsurge in new projects start-ups in the past two years. We expect a slightly higher growth profile for non-OPEC supply in 2012, with a growth of 0.48 mb/d following a growth of 0.15 mb/d in 2011. The fall in North Sea production is expected to continue next year, as technical problems aggravate the already sharply declining mature oil fields. Former Soviet Union output, along with China, has faced considerable technical problems this year and poses downside risk to our forecasts for 2012, should the problems continue. Indeed, there is now a clear demarcation in non-OPEC supply, with growth largely concentrated in the Americas, and declines continuing elsewhere. The key theme going forward will be how much and how fast production in the Americas can grow to offset declines in other parts of the world as significant further increases from current levels remain a difficult enterprise for these non-OPEC supply countries.

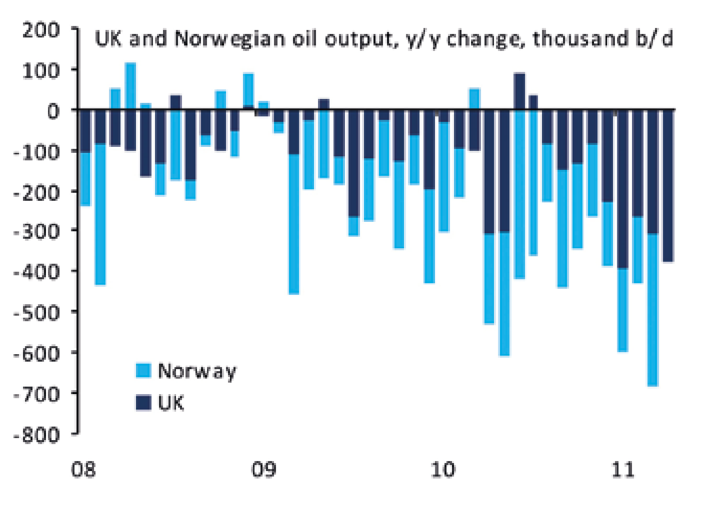
Outside Latin America, most of the growth in American production involves what would largely be classified as unconventional oil. As with most unconventional oil plays, the break-even price required is significantly higher than the bigger, better behaved conventional oil fields, and thus, incrementally, non-OPEC growth is set to come from higher cost areas in 2012 and beyond. Further, while exploitation in reserves in ever deeper waters had in recent years been the key focus, there appears to be an emerging trend that is witnessing the cutting-edge of oil production techniques move back on-shore. Increased uncertainty about costs and regulation after the Macondo spill have imposed a pause on the growth in offshore drilling, and while we expect offshore drilling to continue off South America and Africa, we would expect onshore oil production to generate most of the incremental growth over the next two years.

Finally, the combination of persistent strong demand growth continuing to outpace the momentum in non-OPEC output increases is set to keep the pressure on OPEC, and in particular, Saudi Arabia, high. Thus, unilateral Saudi policy will remain key in 2012. Currently, the Kingdom, much like many OPEC countries, faces extremely challenging geopolitical situations and has been spending heavily. The already high level of spending is set to remain for next year at the very least (we expect a 5 per cent year-on-year increase), given the commitment to pay out extra cash for up to two years. We see little reduction in its defence spending, given the situation in neighbouring Yemen and Bahrain and its heightened tensions with Iran. Based on this planned new expenditure, we estimate that total government spending will increase to 48 per cent of GDP and 45 per cent in 2011 and 2012, respectively. Thus, in our view, current prices are roughly what Saudi Arabia is aiming for; we do not detect any wish to sustain prices at lower levels. The extra spending has pushed price aspirations up by some US$25 per barrel, with US$100 becoming the new US$75 in terms of the midpoint of producer expectations.

Saudi Arabia will likely continue to try to prevent any explosive breakaway in prices, but given the chances of the global imbalance tightening to the extreme, this is likely to remain the biggest challenge for the Kingdom over the coming years.

All this has clear implications for oil prices. In general, the trend of steady growth in demand, with supply attempting to play catch-up at best, creates an environment for higher prices. This is aided further by changing producer aspirations and a heightened geopolitical backdrop. The growth in demand is rather rapidly likely to press against the limits of global supply, with most of the work needed to be done by prices in order to balance the market. In the more immediate term (i.e. 2012), eroding spare capacity and an almost non-existent inventory buffer is likely to keep prices infused with a large degree of dynamism and volatility. ■

North Sea oil production growth



Source: NPDS, DECC, Barclays Capital