King Abdullah Petroleum Studies and Research Center

Oil's Demanding Road to Recovery

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Instant Insight

May 17, 2020

KS--2020-II13

About KAPSARC

The King Abdullah Petroleum Studies and Research Center (KAPSARC) is a non-profit global institution dedicated to independent research into energy economics, policy, technology and the environment across all types of energy. KAPSARC's mandate is to advance the understanding of energy challenges and opportunities facing the world today and tomorrow, through unbiased, independent, and high-caliber research for the benefit of society. KAPSARC is located in Riyadh, Saudi Arabia.

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Through a combination of voluntary and market-driven production cutbacks, as well as increased crude storage measures, OPEC+ and the G20 have banded together to help restore stability to the oil market. As of May 1, OPEC+ members officially began implementing supply limits, with several countries outside the group providing support on their own terms. While this cooperation will provide much needed support to the market, demand-side factors continue to dominate the effects of the pandemic, with the trajectory of the recovery dwarfing the impact of the supply cuts on oil prices. Demand losses now appear to have peaked, and, while inventories are likely to build for some time to come, the fundamentals are swaying back toward a rebalancing.

There are few 'winners' in this crisis

Despite the recent positive developments, with OPEC+ and other countries taking measures to help restore market stability, there still appears to be some confusion in the media of the underlying issues at hand. News stories have appeared throughout the crisis, positing that certain countries are 'winning' from this scenario or blaming some for causing the price collapse. The reality is that the unprecedented drop in demand as a result of the COVID-19 pandemic is in no one's interest, and few immediate positives can be drawn from it. Cleaner skies are possibly one benefit, but the pandemic is not a lasting solution to the problems of pollution and climate change.

While some low-cost producers will fare better than others during this downturn, everyone is facing difficulties. Budgets have been slashed, bankruptcies are imminent, and austerity measures are coming. Even consumers can barely take advantage of the short-term gains offered by lower prices because of the various social containment measures, and they will face the negative effects of volatile oil prices in the longer-term if the market does not return to order. As we discussed in the paper, "The World Needs OPEC, but OPEC Can't Go It Alone," volatility is bad for just about everyone.

Recognizing this, the International Energy Agency (IEA), among other international organizations, pushed for a G20 energy ministers' meeting in April and encouraged the renewed efforts of Saudi Arabia to broker an OPEC+ agreement. Held under the leadership of the Saudi G20 Presidency, the message that emerged from the April 10 meeting was clear: "well-functioning, stable, open, transparent and competitive energy markets play a vital role in bolstering economic activity and global growth." The shared responsibility agreed to at the meeting, and the measures fostered by a voluntary focus group, are part of a broad international agreement that includes both consumers and producers. The goal is to find ways to deal with the crisis in the energy markets caused by the COVID-19 pandemic.

Who is doing what?

As a result of the G20 energy ministers' meeting, several countries outside of OPEC+ introduced measures to help stabilize the oil market. For example, Norway announced its own autonomous supply limits, and Australia has cleverly decided to take advantage of lower prices to increase purchases for its strategic reserves. Various other 'market-based' cuts are ongoing outside of OPEC+, with several non-OPEC+ countries also looking to increase purchases for their strategic stocks (Figure 1).

Figure 1. Supportive developments outside of OPEC+.

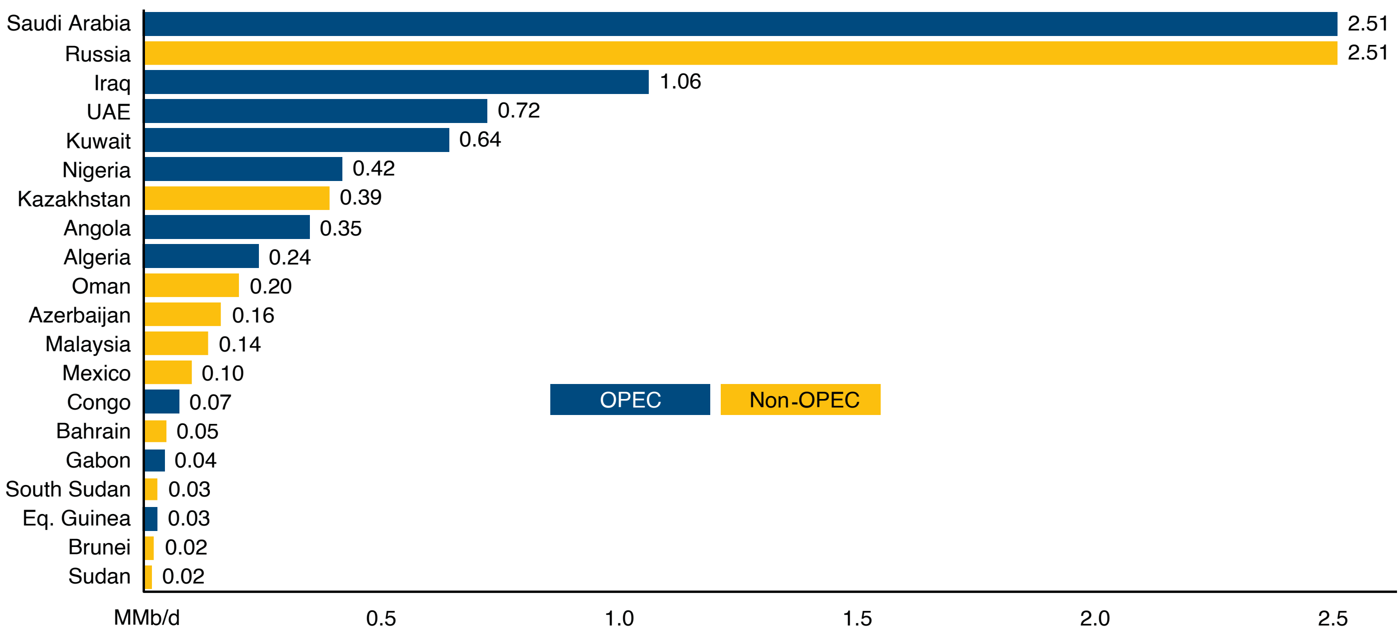
	Country	Details on Developments	*KOMO 2020 supply change estimate (MMb/d)	Likely strategic reserve purchase measures
G20	**United States**	According to Secretary of the Treasury, Steven Mnuchin, the United States is exploring the possibility of storing another "several hundred million barrels" in its Strategic Petroleum Reserve (SPR). The current SPR capacity is reportedly 90% full, with about 77 MMb of space available. The Department of Energy is allowing oil companies to lease space in the SPR, with nine companies already renting 23 MMb of storage. The latest estimates from the U.S. government are for Q1 production to decline by more than 1.5 MMb/d by Q3 of this year.	- 3.10	~ 54 MMb (potentially more)
G20	**Canada**	Most estimates expect at least 1 MMb/d of production in Canada to be shut-in over Q2, with some reports indicating that this level has already been reached.	- 0.34	
G20	**China**	China plans to buy oil for its strategic petroleum reserve. Analysts estimate that this could amount to 80-100 MMb from March to the end of the year, about 300 Kb/d. Production is also expected to naturally decline.	- 0.12	~ 300 Kb/d for 2020
G20	**India**	According to Reuters, India plans to move 19 million barrels to strategic storage facilities by the third week of May. Production was down 5.5% in March year-on-year, with more natural declines expected.	- 0.07	19 MMb for May
G20	**Australia**	The Australian government will spend AU$94m to build its strategic stockpiles, which will be built up initially in the United States as storage in Australia is full.	0.06	AU$94 of purchases announced
	Norway	Norway will cut its production by 250 Kb/d in June and by 134 Kb/d for the rest of 2020. It said it would remain outside of the OPEC+ agreement, acting upon the calls of the G20 to help stabilize the market.	N/A (~ 150 Kb/d of announced supply cuts)	

*KOMO 2020 supply change estimate is the average production level forecasted for 2020 (updated on April 14) subtracted from the average 2019 supply levels.

Source: KAPSARC.

With Russia returning to a new agreement, after its hesitancy to cut in early March, OPEC+ is now cutting on a scale never seen before. As illustrated in Figure 2, the group targets a headline production cut of 9.7 million barrels per day (MMb/d). Leading by example, Saudi Arabia announced a further 1 MMb/d reduction for June on top of its 2.5 MMb/d pledged cut. So far, it has over complied in May, reducing output by more than 3.0 MMb/d from its 11 MMb/d reference level. The United Arab Emirates and Kuwait, both of whom posted high compliance rates to date, have now followed suit, announcing extra cuts of 100 thousand barrels per day (Kb/d) and 80 Kb/d, respectively. Conformity for the rest of OPEC in May looks good, with only Iraq and Algeria appearing to miss their targets. For OPEC+, compliance is likely to be high, with many producers facing forced shut-ins. The KAPSARC Oil Market Outlook (KOMO) estimates that OPEC+'s spare capacity will jump by a massive 4.26 MMb/d from the first quarter (Q1) of 2020 to stand at 7.31 MMb/d in Q2 2020.

Figure 2. Agreed OPEC+ productions cuts for May 2020.



Source: KAPSARC, using OPEC Secretariat data.

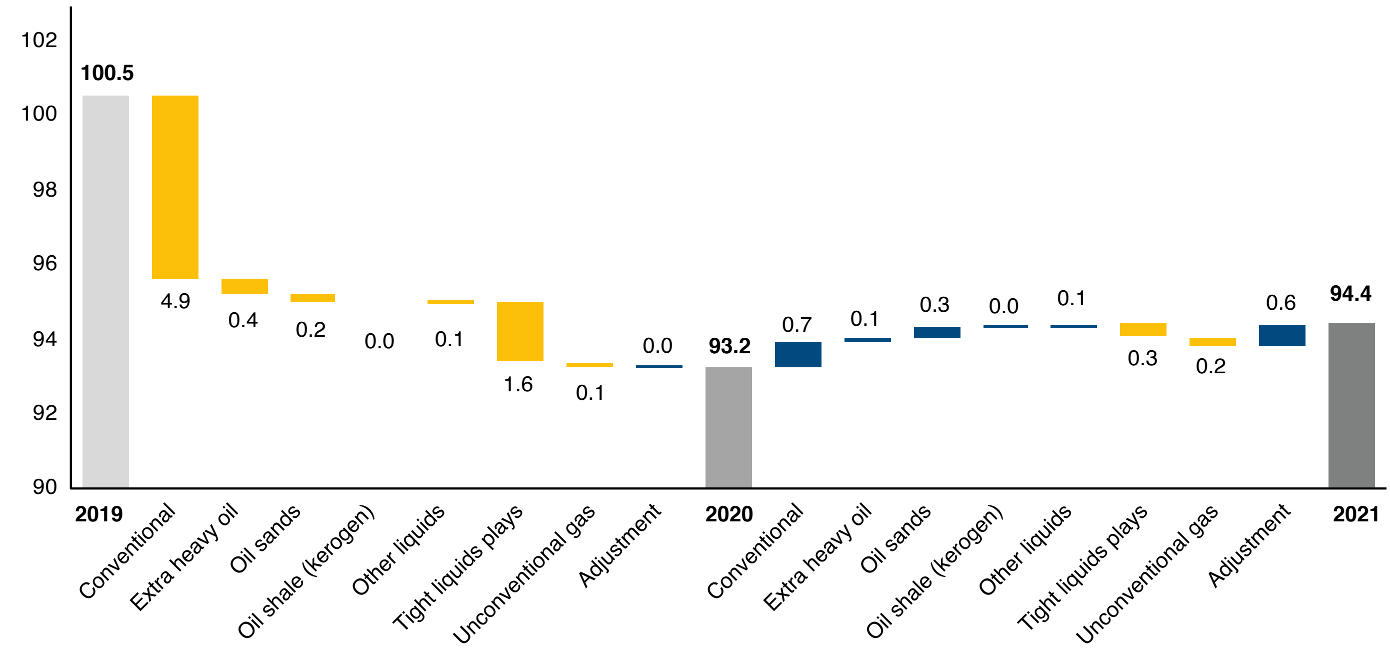
These huge OPEC+ supply cuts, along with the significant market-driven declines in North American production, will help bring supply levels back in line with demand. Putting all the numbers together, KOMO sees global supply falling by 7.3 MMb/d to stand at 93.2 MMb/d for 2020 (Figure 3). While this fall in supply will not balance the market entirely for the year, it will help stabilize prices and likely push the market into a deficit toward the second half of the year, causing inventories to draw.

Demand, demand, demand…

Moving forward, demand will remain by far the biggest variable. So much will depend on the path to recovery from the COVID-19 pandemic, including how quickly containment measures are lifted, whether a second wave of the virus develops, the depth and duration of the economic downturn, and the pace of the recovery – all of which remain highly uncertain.

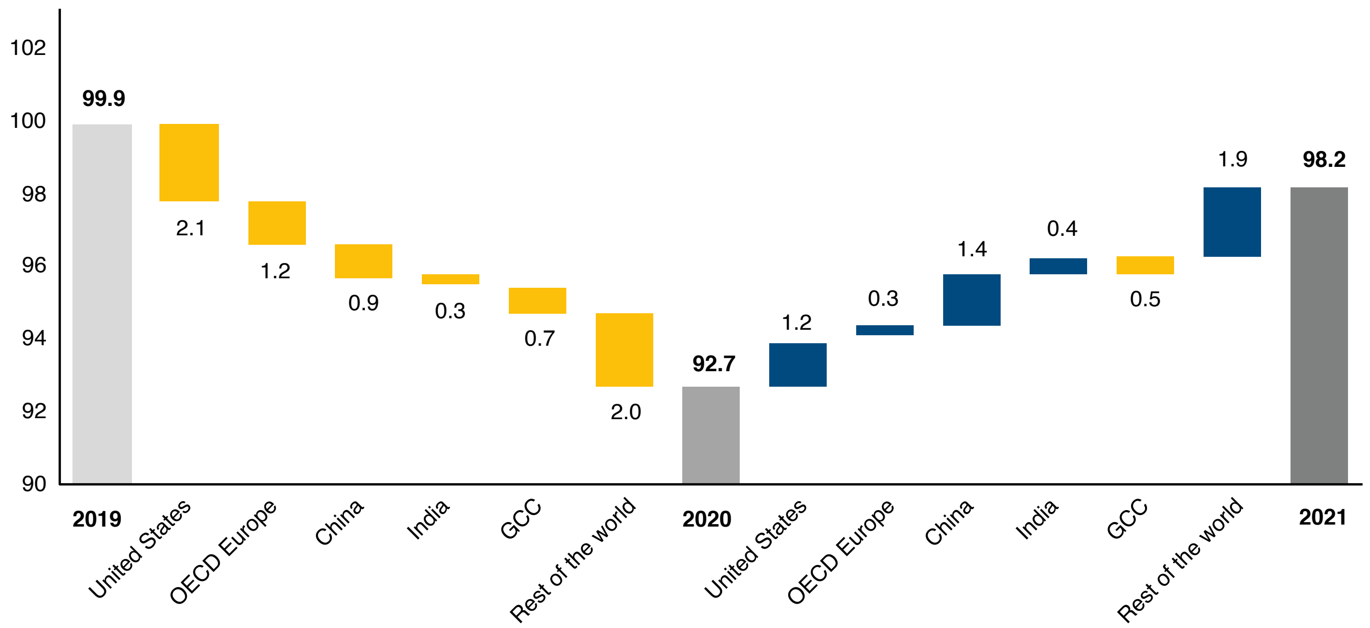
Despite some of the headlines, the current supply and demand imbalance has really been driven by falling demand. The added supply for April due to the unsuccessful OPEC+ meeting was no more than 3 MMb/d. Meanwhile, global oil demand for the same period was down 29 MMb/d on 2019. U.S. demand alone fell by about 6 MMb/d from recent levels, double the amount added to the market due to the initial collapse of the OPEC+ deal. For 2020, KOMO sees demand declining by a total of 7.26 MMb/d and rebounding by 5.61 MMb/d in 2021 (Figure 4).

Figure 3. Annual global liquids supply growth (MMb/d).



Source: KAPSARC, using Rystad data, April 2020.

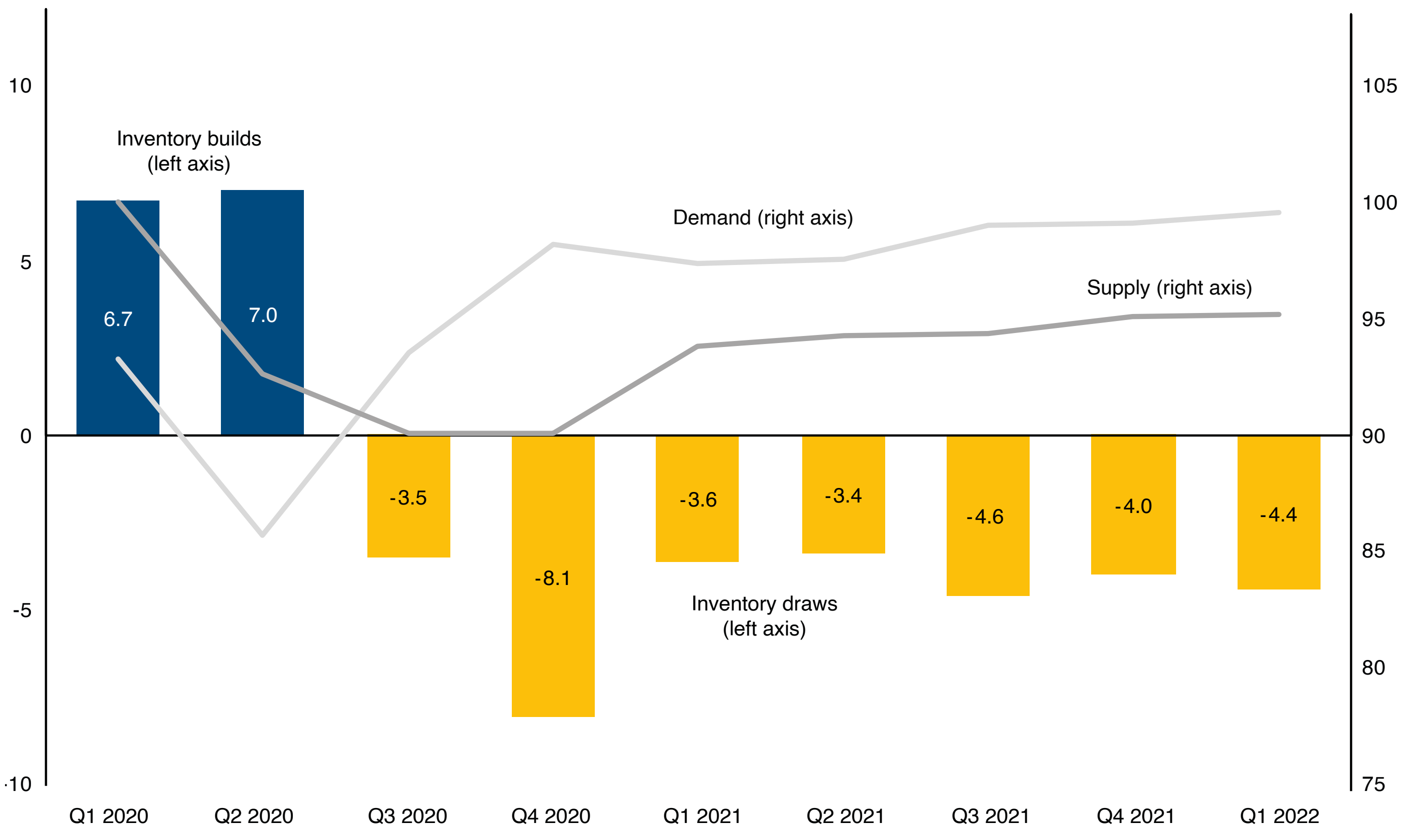
Figure 4. Annual global oil demand growth (MMb/d).



Source: KAPSARC, April 2020.

Inventory levels will dictate price movements. In the very near term, prices could still see additional downward pressure. The decline in demand still exceeds the fall in supply, and, if global inventory capacity is reached, prices could drop and force additional shutdowns in production. The market is also still in contango, further supporting inventory builds. For these reasons, oil price volatility is likely to remain high in the near term. However, with a gradual recovery in demand expected, and growing reductions in supply, prices will eventually increase when inventories start to draw down, which KOMO sees happening in the second half of 2020 (Figure 5).

Figure 5. Quarterly global oil supply and demand balance outlook (MMb/d).



Source: KAPSARC, April 2020.

While we still expect the loss in demand to outweigh the decline in supply in the short term, for now, at least, positive signs are emerging. Demand losses appear to be subsiding with global economic activity restarting as the COVID-19 infection curve flattens out. KOMO sees inventories peaking this quarter and beginning to fall in Q3 2020, with draws continuing throughout 2021.

To the collective benefit of producers, consumers, and the global economy, oil market fundamentals are improving. A pick-up in demand and a massive drop in supply is paving the way for an oil market road to recovery.

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