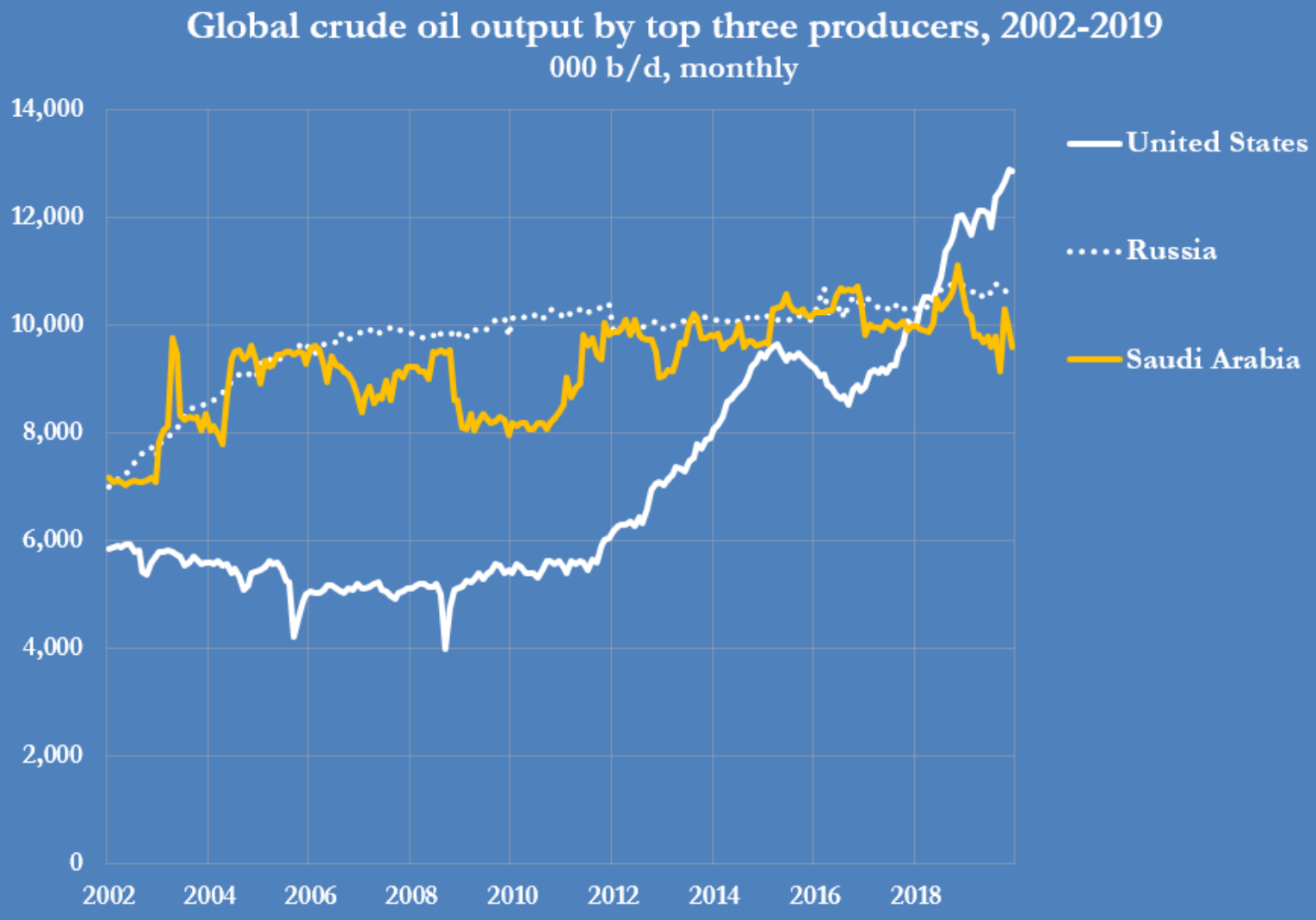
Volume warfare in the oil market

Saudi Arabia, Russia, the United States and the balance of power

JOHN KEMP
REUTERS
11 Mar 2020

Saudi Arabia and Russia have lost market share to the United States

U.S. output has doubled since 2011, while Saudi and Russia output has stagnated



Source: Joint Organisations Data Initiative

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U.S. shale sector has become marginal supplier to the global market

Shale has captured all incremental global consumption when Brent >$70 per barrel

Global oil consumption and production, 2012-2019

Incremental million barrels per day

	Global oil consumption	U.S. crude production	L48 crude production ex Gulf	U.S. supplies all global incremental consumption?
2012	1.0	0.9	0.9	*NO*
2013	1.6	1.0	1.0	*NO*
2014	0.9	1.3	1.2	YES
2015	1.9	0.7	0.5	NO
2016	1.7	-0.6	-0.7	NO
2017	1.7	0.5	0.4	NO
2018	1.4	1.6	1.6	YES
2019	0.8	1.2	1.1	YES

Sources: BP Statistical Review of World Energy, U.S. Energy Information Administration

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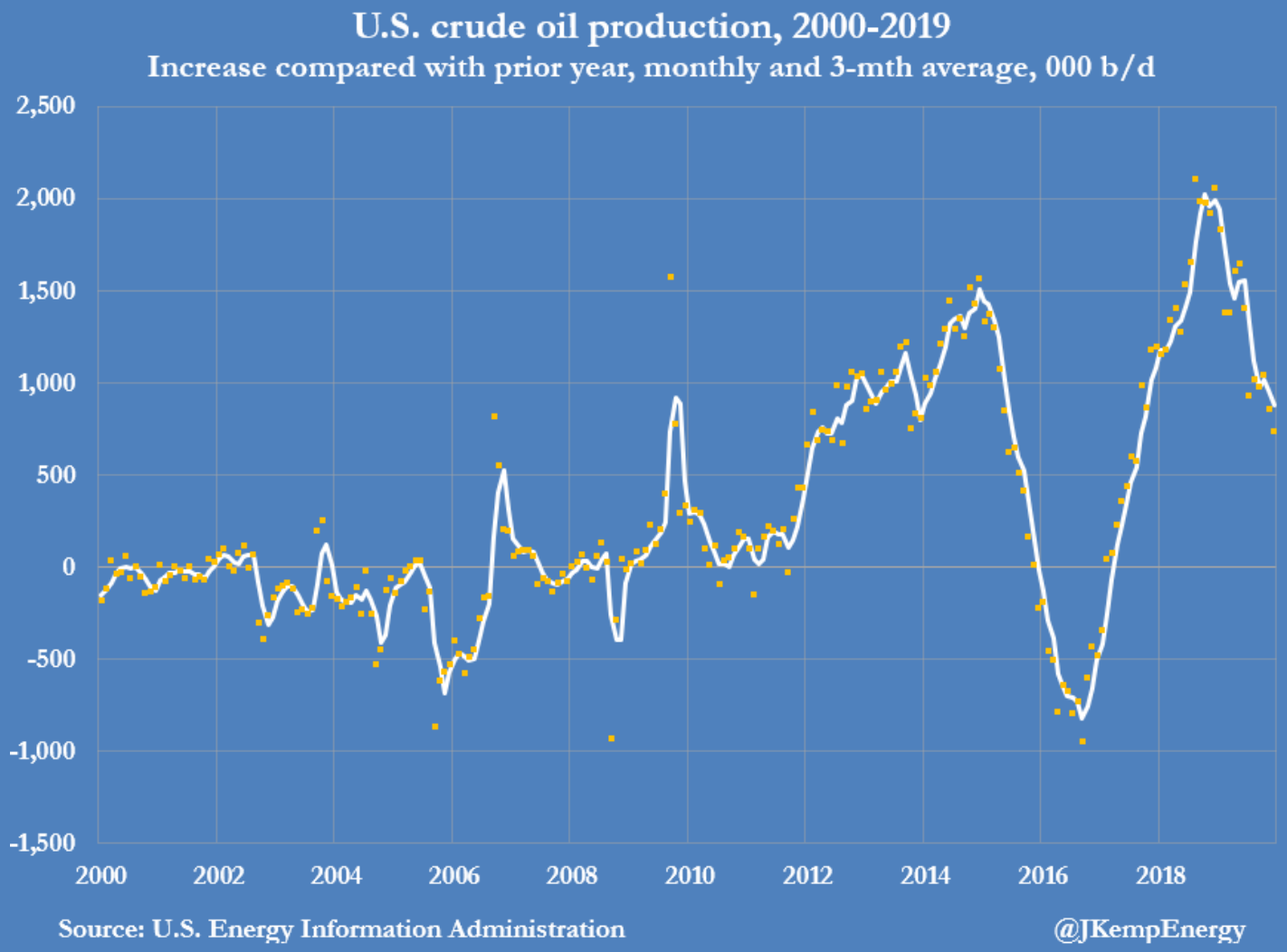
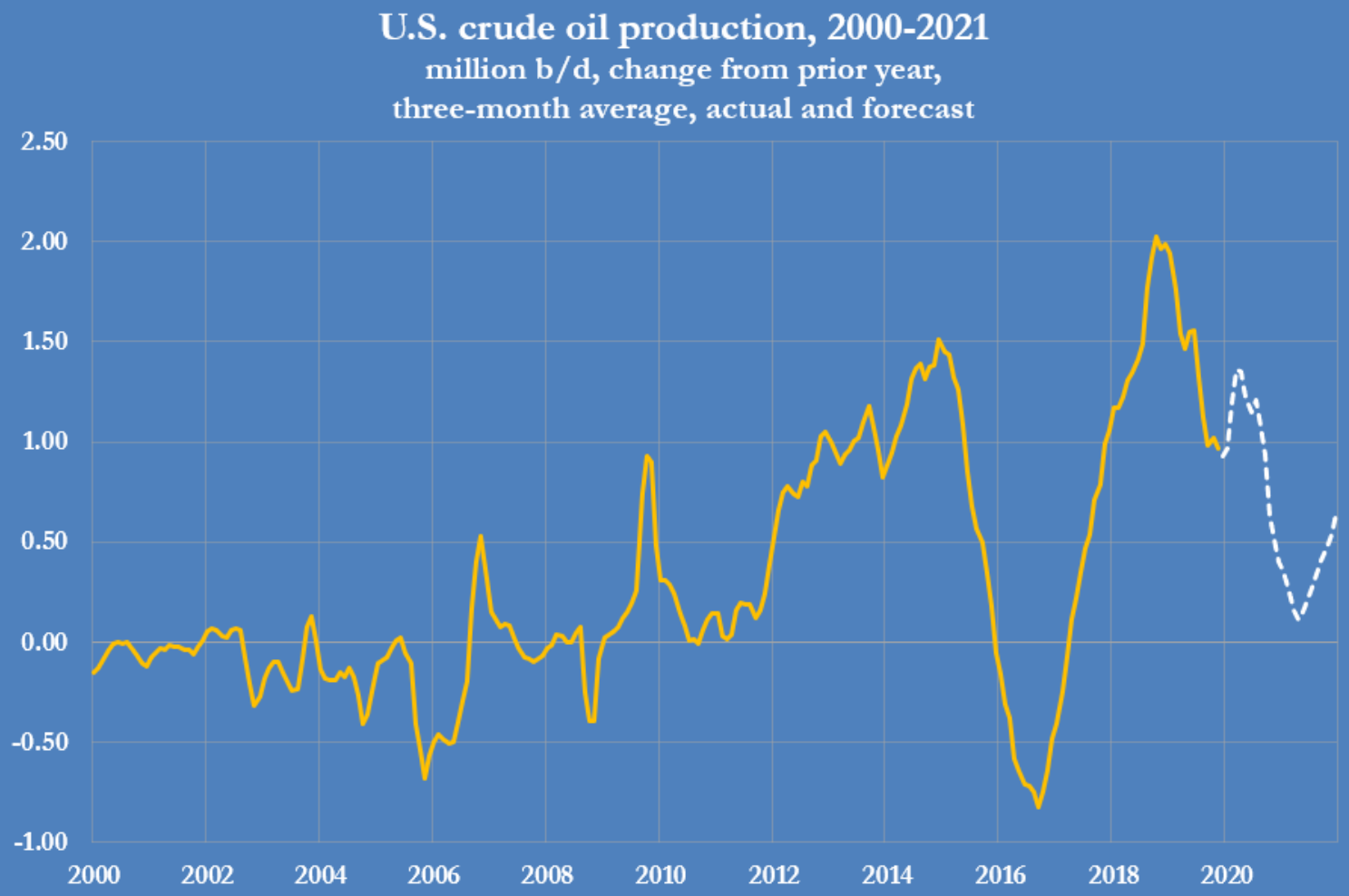
U.S. shale production has recorded fastest increase anywhere in history

Second shale boom (2017-2019) was adding +2 million b/d per year at its peak



U.S. oil production growth forecast to slow even before outbreak of volume war

Growth predicted to slow to +0.4 million b/d by Q4 2020 and +0.6 million by Q4 2021



Source: U.S. Energy Information Administration ("Short-Term Energy Outlook", Jan 2020)
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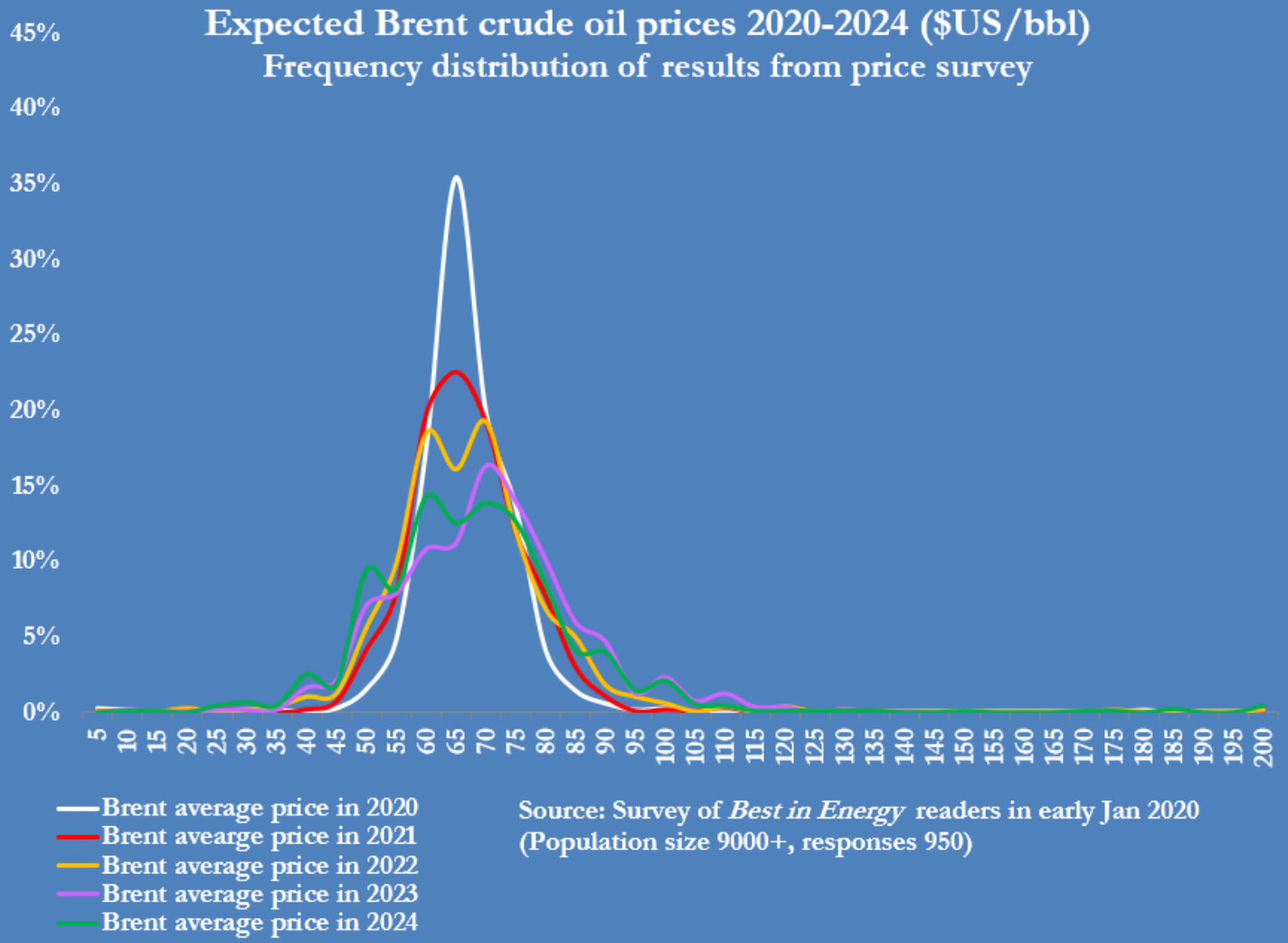
Oil prices expected to remain anchored around $65 per barrel through 2024

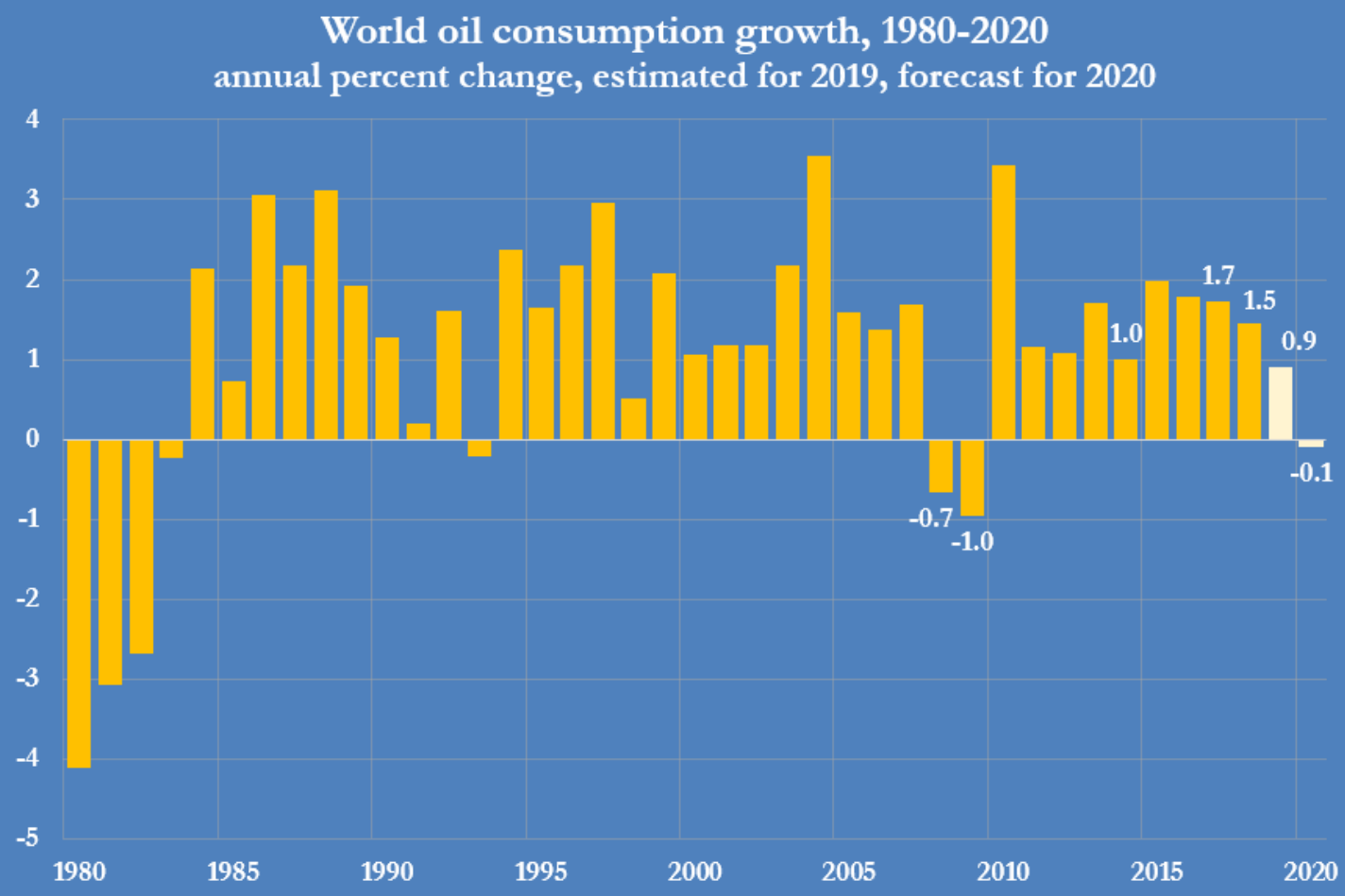
U.S. shale acts as price maker, but cyclical volatility around average level



Source: Survey of *Best in Energy* readers in early Jan 2020
(Population size 9000+, responses 950)

Global oil consumption hit by trade war in 2019 and now coronavirus in 2020

Consumption growth well below long-term trend of 1.4% per year in both years



Source: *BP Statistical Review of World Energy 2019*

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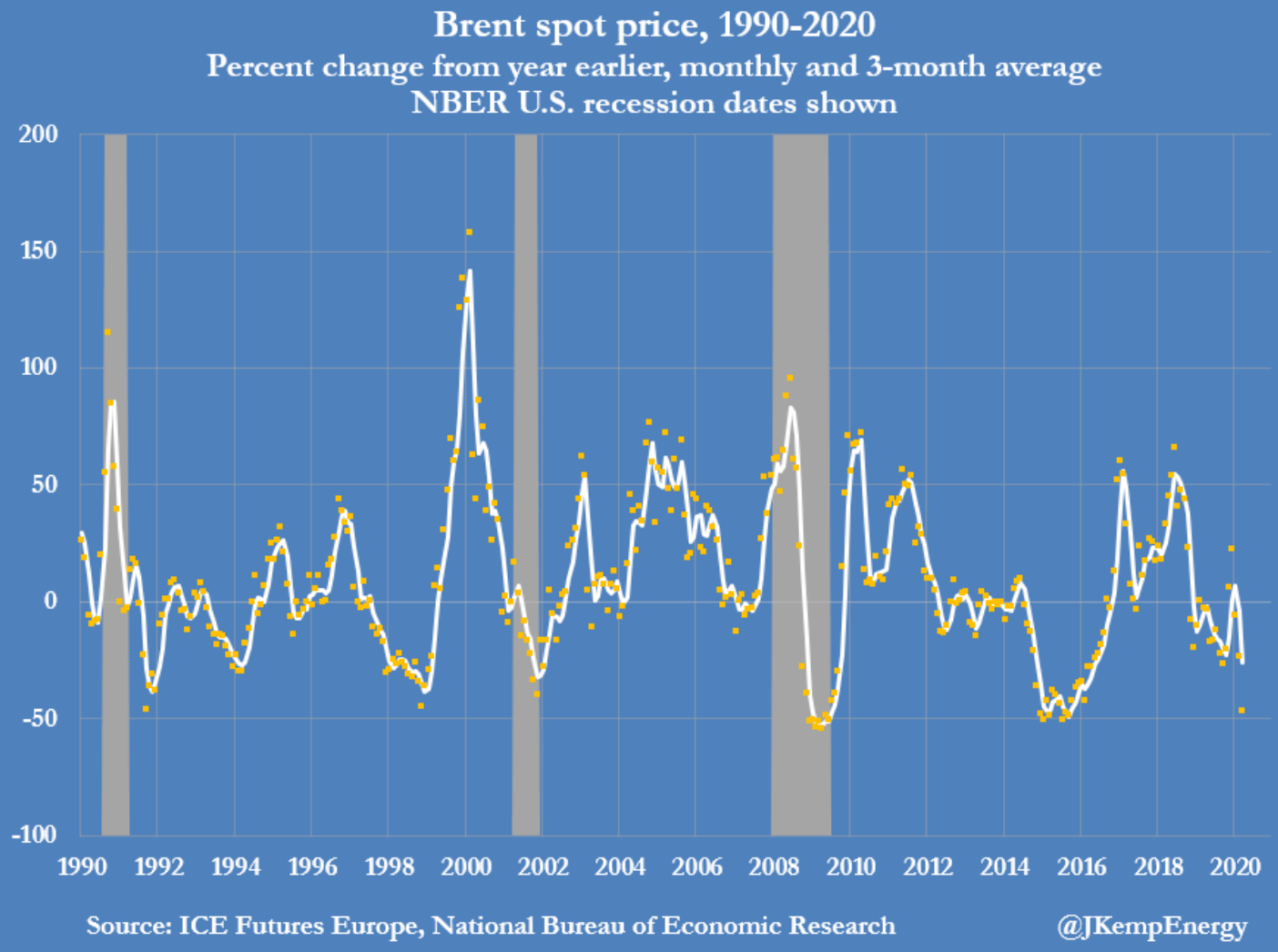
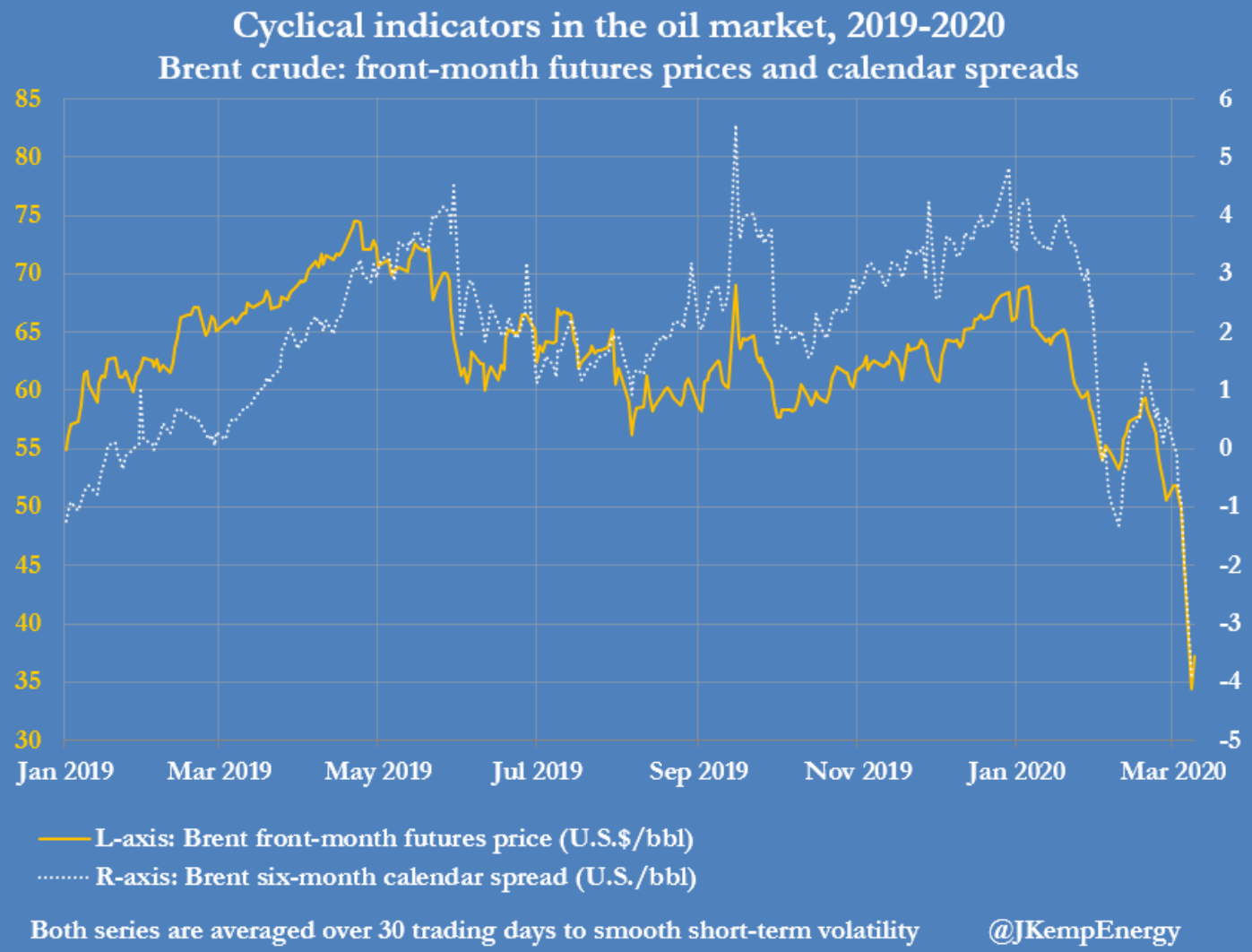
Oil prices decline in response to deteriorating economic outlook

Decline consistent with synchronized global economic slowdown or recession



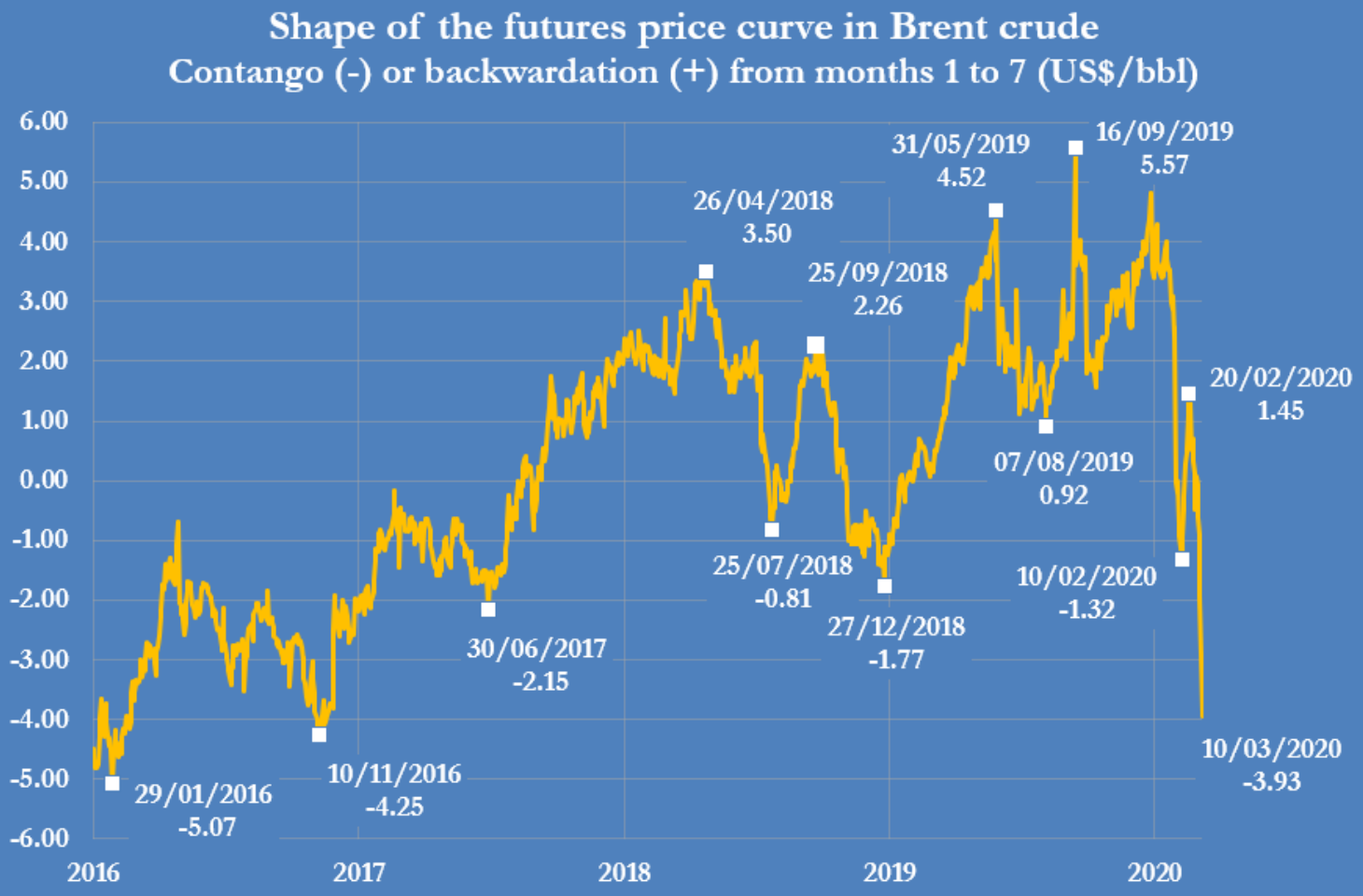
Spot prices and calendar spreads have been sliding since the start of the year

Coronavirus weighing on market even before volume war



Brent spreads plunged after OPEC+ failed to agree on further output restraint

Saudi Arabia and Russia subsequently threaten to increase production

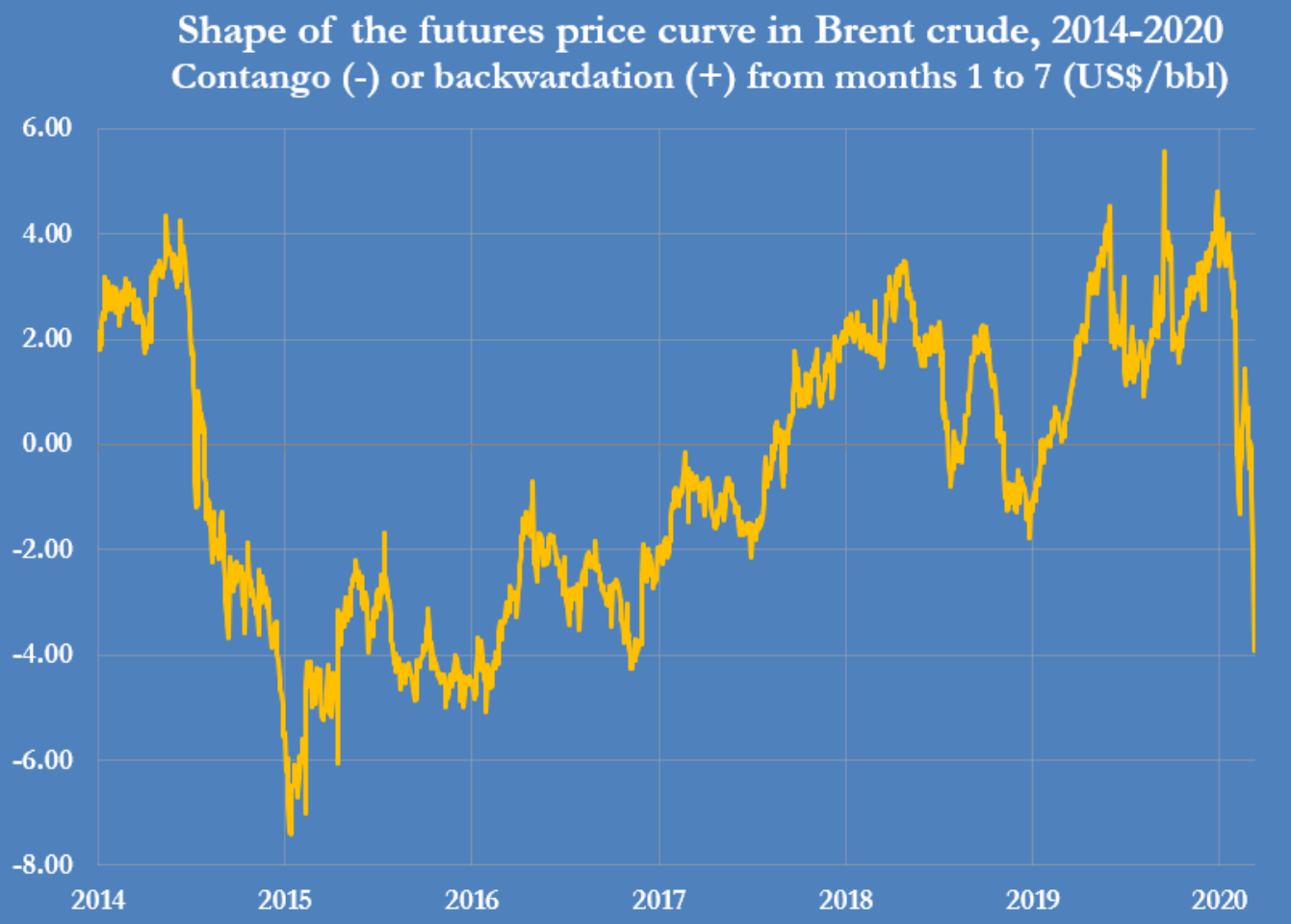


Price difference Brent month 1 and month 7 (U.S.$/bbl)
Contango (-) or backwardation (+)

Source: ICE Futures, @JKempEnergy

Oil traders anticipate significant over-production and large build in inventories

Brent calendar spread reverts to largest contango since Nov 2016 (before OPEC+ launched)

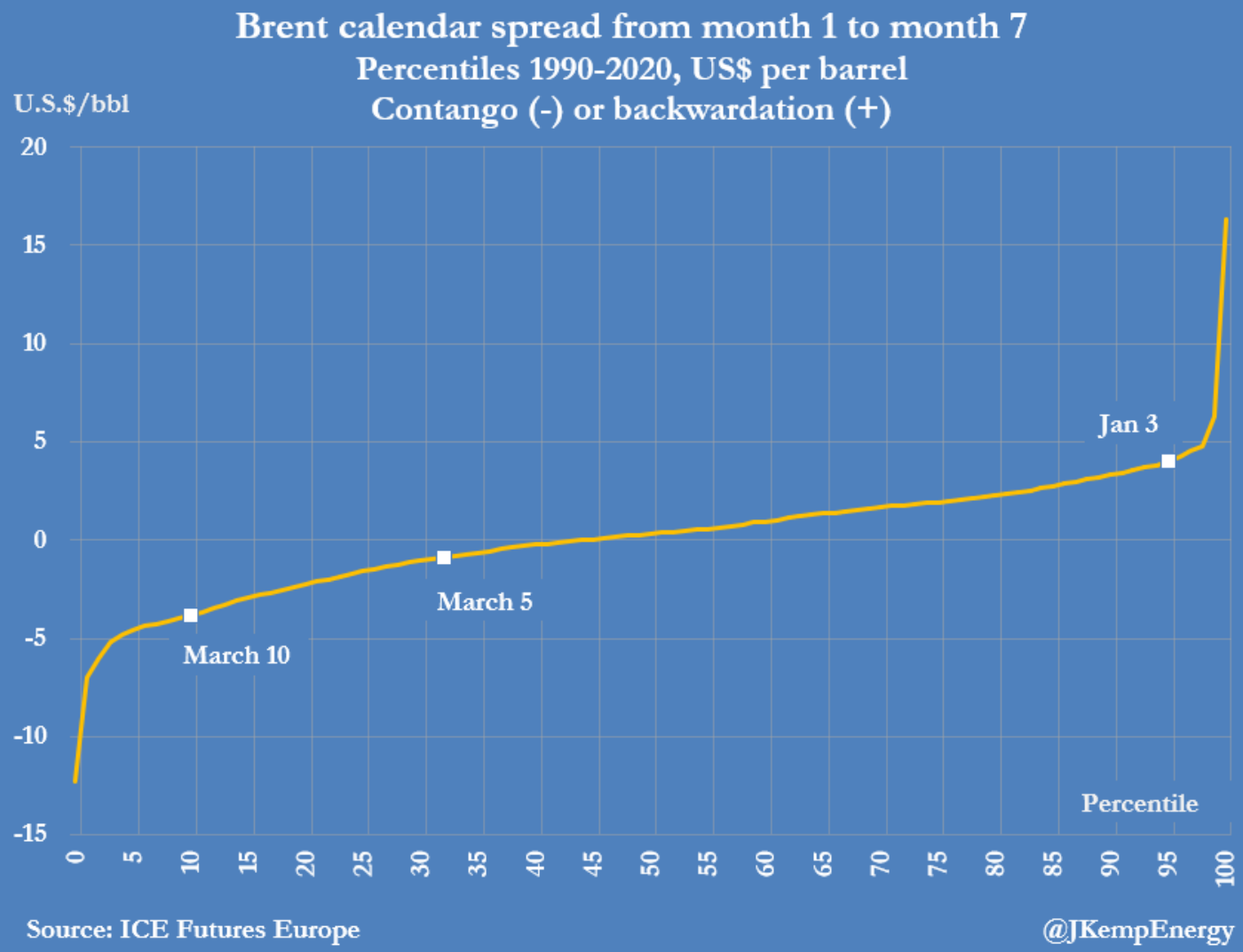


Price difference Brent month 1 and month 7 (U.S.$/bbl)
Contango (-) or backwardation (+)

Source: ICE Futures, @JKempEnergy

Brent calendar spread signaling large inventory build

Six-month spread in 10th percentile for all trading days since 1990



Source: ICE Futures Europe

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Strategic choices for Saudi Arabia and Russia
Protect prices or defend market share

Russia's strategy
- Stop erosion of market share
- Allow prices to fall in response to coronavirus
- Eliminate oversupply via price adjustment
- Force further slowdown in U.S. shale
- Incentivise faster consumption growth
- Permit long-term expansion of Russia output

Saudi Arabia's strategy
- Stop erosion of prices
- Accept further (temporary?) loss of market share
- Eliminate oversupply via $OPEC^{+}$ output adjustment
- Extend and deepen $OPEC^{+}$ production restraints
- Maximize short-term oil revenues

Volume warfare breaks out after OPEC+ fails to agree on deeper cuts

Other outcomes were possible but Saudi Arabia and Russia elected for volume war

Russia elects to end production controls rather than deepen them, preserves ability to raise output , force further reduction in shale production and defence market share

Saudi Arabia opts to go into punishment mode and communicates maximum pain strategy to market

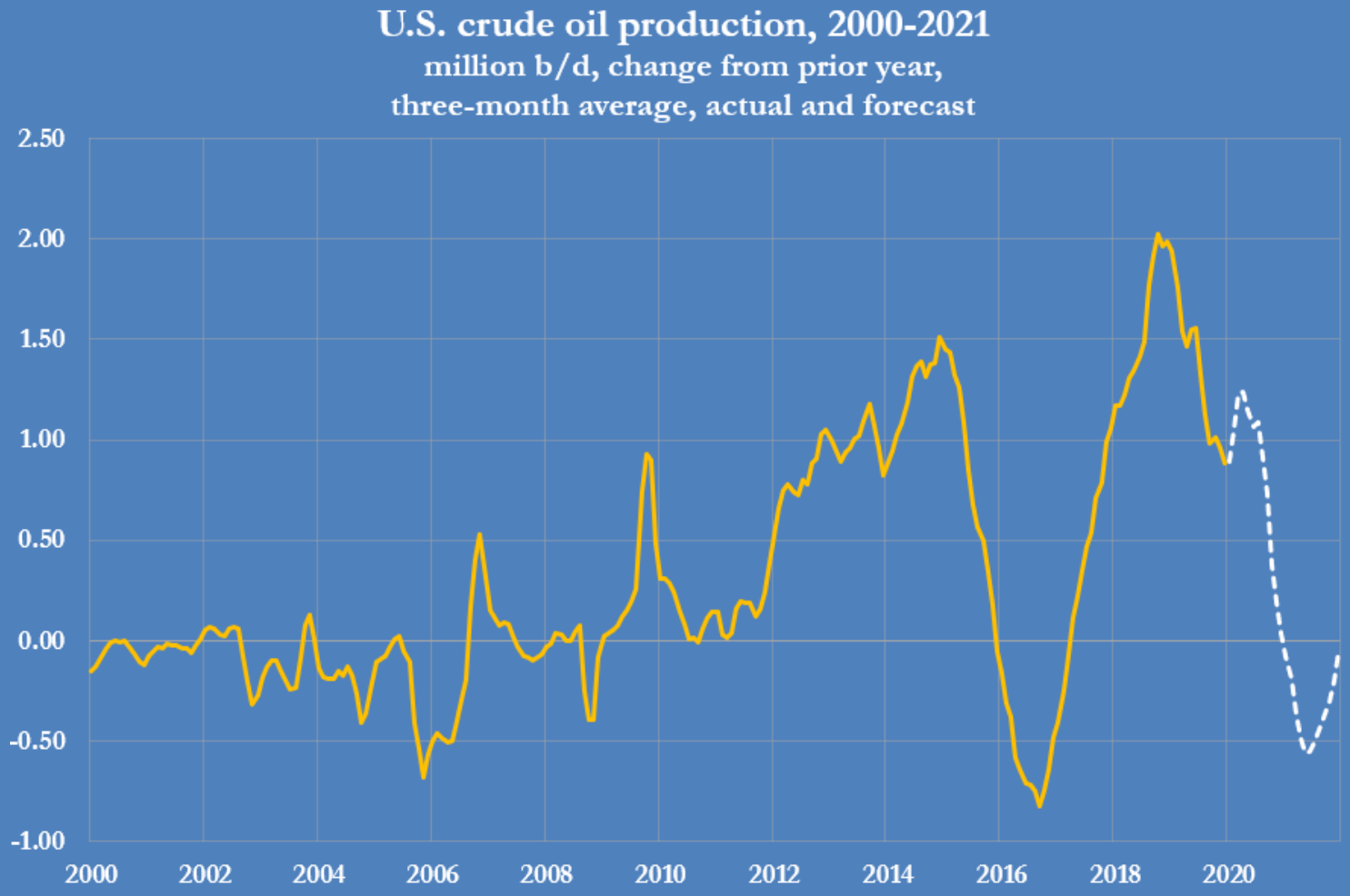
- Signals flat out production
- Supply extra oil from stocks
- Increase maximum capacity

Escalate-to-negotiate strategy

- Attempt to engineer short-term crisis
- Force Russia to negotiate
- Force White House to intervene
- Avoid protracted period of low prices

U.S. oil production forecasts revised down as a result of lower prices

Production expected to be roughly flat year-on-year in Q4 2020 and 2021



Source: U.S. Energy Information Administration ("Short-Term Energy Outlook", Mar 2020)
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Volume warfare

Strategy and outcomes similar to analysis of armed conflict

Volume warfare usually breaks out because one side or both miscalculates resolve or capacity to absorb pain, its own or others

Top policymakers sometimes opt to fight rather than appear weak in front of domestic and international audiences

Volume warfare tests resilience – willingness and ability to absorb short-term financial pain to protect long-term interests

Volume warfare establishes new balance of power or re-establishes deterrence among major producers