CRUDE OIL OUTLOOK

By Glenn Wepener

Overview

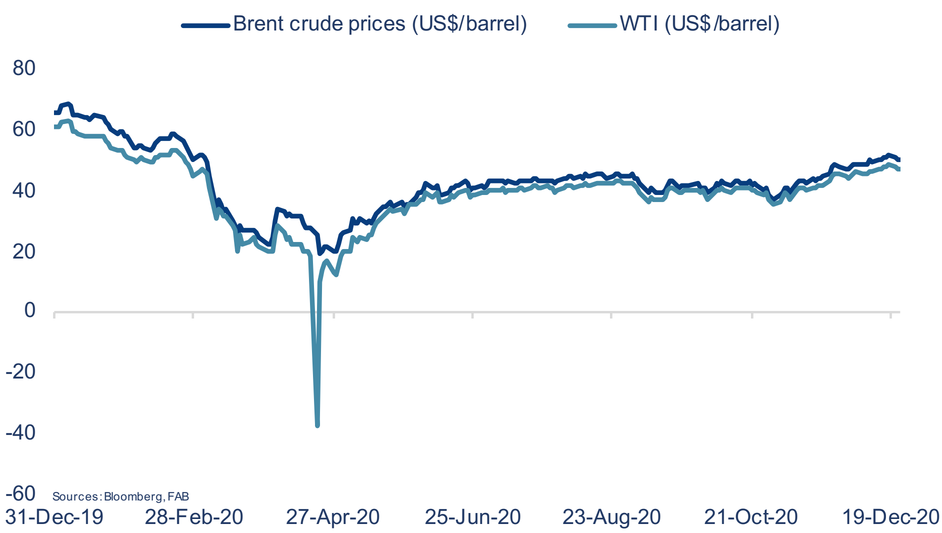
The oil industry looked poised for a reasonably profitable year at the start of 2020, but it turned out to be one of the most difficult on record for crude producers and refiners. Demand fell off a cliff due to the economic impact of the Covid-19 restrictions, while the short but sharp price 'war' which took place during the first quarter of the year put additional pressure on prices. As the outlook for the world economy has begun to brighten, driven by the emergence of vaccines, oil demand (and prices) should slowly continue to recover in the year ahead, although a return to the levels recorded in 2019 is probably not going to occur until 2022.

Demand & Supply

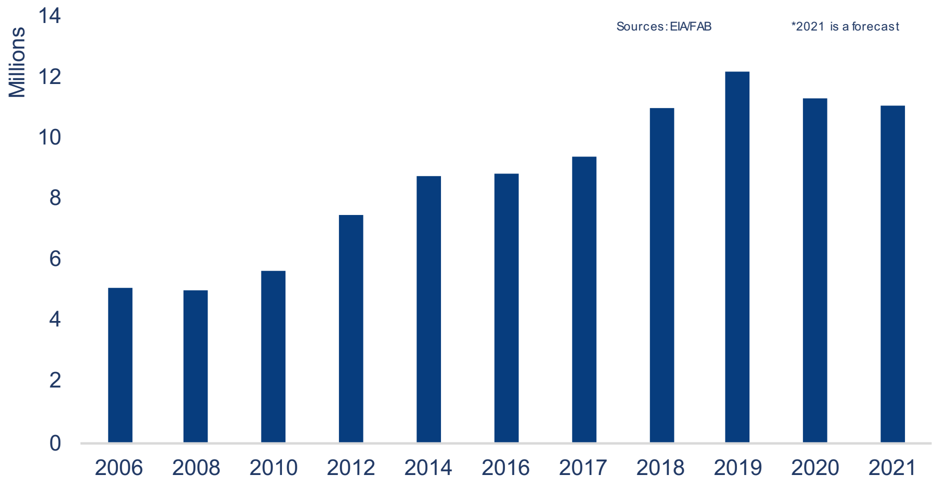
After a decade of growth, the global demand for petroleum and liquid fuels is likely to have fallen to 92.38 million barrels/day in 2020, about 8.8 million barrels/day lower than the previous year, according to an EIA report published in November. Meanwhile, the drop in demand for some important fuels such as jet fuel was particularly dramatic, as the aviation sector experienced its worst year on record, losing more than US$118 billion during 2020 according to IATA. This was highlighted in a recent International Civil Aviation Organization report, which showed that global passenger traffic fell by as much as 60% last year compared to 2019.

Refiners, too, had an awful 2020 as their margins collapsed. This in turn triggered a jump in the number of permanent plant closures, especially in more mature markets such as Europe and the US, with the latter's overall refining capacity slipping to its lowest level since 2016. However, ongoing refinery expansion and new builds in China, India, and the Middle East should see global capacity increase between 2021 and 2025.

Despite this dismal picture, a reasonable recovery in demand from the key markets of China and India towards the end of last year should gather pace in 2021, eventually including other economies as lockdowns ease and vaccine rollouts proceed. In fact, India's largest state-owned refiner, the Indian Oil Corporation (which operates



Average annual US crude production barrels/day



11 of the country's 23 refineries), was reportedly running its plants at full capacity in November and December as demand for gasoline and diesel reached pre-pandemic levels. The EIA currently anticipates consumption to average 98.2 million barrels/day this year.

On the supply side, the EIA estimates average crude production to have been 94.25 million barrels/day last year, resulting in a marked rise in global inventories. However, this overhang is expected to ease back to its five-year average during the first half of 2021. A renewed OPEC+ output cut accord has been the major driver helping oil prices rebound back above the US$40/barrel level, after touching record lows in April last year. Therefore, December's decision by signatories to the accord to only reduce their overall production cut by 500,000 barrels/day (to 7.2 million barrels/day), instead of an earlier planned 1.9 million barrels/day taper in January, was equally important in keeping a floor in place as the world's economy sputters back into life.

US Shale

Job losses, together with a steep fall in the number of active oil rigs in the US last year, underline some of the pain felt in the sector as the price of WTI nose-dived. A Deloitte report published in October stated that the oil, gas, and chemicals industry in the US shed 107,000 jobs between March and August of 2020, describing this as the "fastest rate of layoffs in the industry's history".

Meanwhile, in the first week of December there were 338 oil rigs active across the country, a good recovery from the low of 172 in July last year, but still sharply down from the 667 rigs reported to have been operating during the same period in 2019.

In reality this industry was already facing major cash flow issues prior to the outbreak of Covid-19, and despite record output. According to law firm Haynes & Boone, there were more than 500 bankruptcies of North American producers and oilfield service firms reported between January 2015 and October 2020. In fact, things would have probably been a lot worse last year had the US government not provided an estimated US$10-US$15 billion in direct and indirect relief to the US conventional energy sector.

This ongoing situation has led to a drop in overall production, and even if crude prices grind higher in 2021/22 as we anticipate, it seems unlikely that US output will return to the record monthly level of 13 million barrels/day achieved in November 2019 anytime soon, especially considering the ongoing challenges faced by fracking firms. Comments made by various high profile shale industry figures in recent months also appear to support this outlook.

For example, the CEO of Pioneer Natural Resources was quoted by Bloomberg as saying, "I see no more growth until 2022, 2023, and it will be very, very light in regard to the U.S. shale industry ever growing again." This view was replicated in an IEEFA report that looked at the large drop in capital expenditure by shale oil and gas firms this year, which in turn led to better financial results in Q320 suggesting that, "Moving forward, US shale companies may continue to restrain capital spending to conserve cash and stave off bankruptcy. But these results reinforce the idea that the oil and gas industry has pulled back from investing in its future and instead has settled for managing its own decline."

Meanwhile, with regard to the much-debated 'fierce competition' between US producers and their OPEC counterparts, it was interesting to read the blunt comments made recently on this very topic by Bill Thomas, CEO of the largest independent shale oil producer in the US (EOG Resources), who was quoted by Bloomberg as saying, "In the future, certainly we believe OPEC will be the swing producer, really, totally in control of oil prices. We don't want to put OPEC in a situation where they feel threatened, like we're taking market share while they're propping up oil prices."

Biden's 'Green New Deal'

President-elect Biden's proposed plans to combat climate change and transition away from fossil fuels have raised the question of whether new environmental restrictions will put even more pressure on the US oil and gas sector. Our view is that, while the Biden administration will probably implement tighter controls over emissions and the issuance of drilling licenses on federal land, as well as block the construction of some new pipelines, it is for various reasons unlikely to introduce any severe measures.

Firstly, the Democrats have a slimmer majority in the House than they had prior to the 2020 election, and they recognize that key blue states like Pennsylvania and New Mexico, which helped put Biden in the White House, rely heavily on the oil industry for both jobs and tax revenues. They will therefore have to tread carefully when considering any possible draft bills that would significantly penalize the sector.

It is worth bearing in mind, too, that Biden's first orders of business will be to ensure the vaccination program is rolled out quickly and efficiently, and to concentrate on getting the US economy back on its feet. A reasonably quick economic recovery should in turn boost crude prices and provide some relief to the US oil industry, which is currently more concerned with consolidation and cash flows than any renewed 'green energy' drive. Finally, it is very possible that considering his age, Biden may choose to be a one-term President, and four years is nowhere near enough time for any administration to transform a 120-year industry in a significant manner.

Regional Developments

Another question on the geopolitical front is Biden's anticipated attempt to resuscitate the Joint Comprehensive Plan of Action (JCPOA) accord with Iran. The possible return of Iranian crude to the world market could have a significant impact on prices. However, although a Biden administration, together with the EU, is likely to seek a new agreement with Tehran, this will not be at all easy to achieve.

Any new deal would have to include strict restrictions on Iran's missile program and a firm commitment to halt its regional proxy activities, otherwise Biden would be unlikely to receive enough support in Congress or from America's key allies in the Gulf. Conversely, the hardliners in Iran have already said many times that their country's missile development program is a "red line".

Meanwhile, an important recent regional market development is this year's planned launch of 'Murban' oil futures contracts on the ICE Futures Exchange in Abu Dhabi. Murban is a light, moderate sulphur crude oil, and thus very attractive to Asian refiners. Speaking soon after the announcement of this plan in November last year, ADNOC's Group CEO and the UAE's Minister of State, HE Sultan Ahmed Al Jaber, was quoted as saying: "Having a new, independent exchange in Abu Dhabi will not only benefit the UAE, but also physical and financial oil traders around the world".

In November 2020, the UAE announced its discovery of 22 billion barrels of recoverable unconventional onshore oil resources and 2 billion barrels of recoverable conventional oil reserves. The latter find raises the UAE's recoverable conventional oil reserves to 107 billion barrels, the sixth largest in the world.

Forecasts

This past year has been a tricky one for oil analysts, as a health crisis is a very different situation to gauge, compared to a more straightforward economic one. However, FAB's call in March last year for Brent to average US$40 a barrel in 2020 was reasonably accurate. We remain optimistic that once the pandemic begins to recede, oil prices will continue to recover slowly in the year ahead as the health of the world economy also improves. We therefore expect Brent to average US$58 in 2021, and US$65 in 2022.