Prospects for the oil market in 2012

Friday, November 4 2011

An Oxford Analytica Prospect


A view of a new oil refinery in Baghdad, Iraq.(REUTERS\Mohammed Ameen)

Oil demand in 2012 appears likely to undershoot current expectations, and that possibility does not yet seem to have been fully factored into prices. However, expected demand and supply are well balanced and given the historic degree of forecasting error no clear direction predominates.

What next

Even if the price bias is downwards, unexpected supply outages, whether technical or political, could still prove key factors in next year's oil market. Saudi policy will probably be directed at maintaining strong prices. A reappraisal of the potential of shale oil could prove the technological wild card.

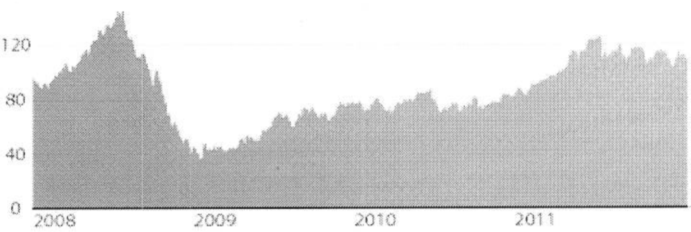
Strategic summary

- MENA instability will remain a major source of uncertainty for the oil market.
- The WTI-Brent spread could erode over the course of 2012.
- Growing Asian demand will offset contraction in OECD demand.

Analysis

Oil demand forecasts for 2012 have been scaled back as the global economy deteriorated in recent months (see PROSPECTS 2012: Global economy - October 31, 2011). Supply problems appear to be easing, with the resolution of production glitches in the North Sea and the likely resumption of a limited quantity of Libyan exports.

OPEC spare capacity is forecast to rise in 2012. Expected demand growth set against increases in non-OPEC supply, and OPEC Natural Gas Liquids are balanced. Both the weakening demand trend and the increase in oil sector capacity over five years of high prices suggest a downward direction for prices in 2012.



Brent oil prices, Jan 08 - Oct 11
Dollar, barrel
Source: Bloomberg

However, oil prices will, as ever, be determined by an eclectic mix of political, economic and financial factors (see INTERNATIONAL: Commodity 'financialisation' adds risk - August 19, 2011). For the moment, the world is seeing elevated oil prices and consumption levels (see INTERNATIONAL: Oil prices resist major correction - October 12, 2011):

- World oil consumption is expected to end the year at 88.4 million barrels a day (b/d), based on US Energy Information Administration (EIA) data, the highest level yet.
- Physical Brent prices averaged 111.66 dollars a barrel (dollars/bbl) in 2011 to end-October, in comparison with an average of 106.93 dollars/bbl in the same period of 2008, which saw prices spike above 140 dollars/bbl and fall towards the end of the year with the financial crisis.
- Despite recent forecast cuts, demand is still expected to grow by a further 1.20-1.44 million b/d next year.

MENA uncertainty

The greatest material loss to oil markets resulting from instability in the Middle East and North Africa (MENA) region this year was of 1.3 million b/d of Libyan exports, the bulk destined for European refineries. This volume was replaced primarily by Saudi Arabia, but only slowly. Following the killing of former leader Muammar al-Qadhafi in October, Libyan production is expected to rise to about 700,000 b/d by the end of 2011. However, pre-conflict output of nearly 1.7 million b/d is not expected to recover fully until 2013-14.

The key MENA region oil producers have pacified social unrest through a combination of repression and spending. Nevertheless, both Yemen and Syria are also facing political instability and there is no certainty that the new North African governments can fulfil the aspirations of the Arab Spring. The unrest has strained regional relations and upset the former balance of power in the Middle East. MENA instability will remain a major source of uncertainty for the oil market in 2012.

700,000 barrels per day

Expected Libyan production by end-2012

Saudi OPEC role

The Libyan crisis highlighted once again that Saudi Arabia determines OPEC policy by virtue of its domination of the organisation's spare capacity. This fell in 2011 to 3.02 million b/d from 3.99 million b/d in 2010. Yet it is expected to rise again to 3.46 million b/d in 2012. Between 2003 and 2010, Saudi Arabia's proportion of OPEC spare capacity ranged between 64% in 2003 and 85.4% in 2010, hitting a high of 97.4% in 2008.

Although 2008 demonstrated that output can be a blunt tool for controlling a complex global market, Saudi policy remains a key determinant of prices:

- Riyadh has made spending commitments that imply an average crude oil price closer to 100 dollars/bbl than the 70-80 dollars/bbl Saudi that Oil Minister Ali al-Naimi formerly touted as ideal.

- Riyadh has acted in the past to increase output to avoid both risks of recession and demand destruction through substitution. However, it has tended to act in response to high prices rather than to pre-empt them.

- The kingdom appears to have reined in output at the first sign of a resolution to the Libyan crisis.

Brent-WTI

Oil prices have been high, but not uniformly so. The spread between inland US markets, represented by the physical benchmark West Texas Intermediate (WTI), and international markets, represented by Dated Brent, reached record levels in 2011. This reflected higher US domestic output and increased Canadian imports, combined with the logistical constraints around the Henry Hub pricing point and the inability to take crude by pipeline south from there to the Gulf coast (see INTERNATIONAL: Asian market needs new oil benchmark - May 11, 2011).

Falling US stocks towards year-end appear to be the result of more refiners managing to grab some of the huge arbitrage between WTI-priced crude inland and Brent-priced oil products on the eastern seaboard. Crude is increasingly being moved around the United States by rail and lorry. This suggests that the current wide Brent-WTI spread is not a permanent feature and likely to erode over the course of 2012.

Yet despite WTI being significantly cheaper than Brent, the demand outlook in the United States looks no better than in Europe, and much worse than in Asia:

- US gasoline demand remains depressed. The US EIA sees the country's liquid fuels consumption down 230,000 b/d in 2011 from 2010, reviving by only 90,000 b/d in 2012.

- The speed of Chinese oil demand growth appears to have slowed in recent months. Apparent oil demand, which does not take into account changes in product inventories, dropped below 9 million b/d in both August and September. Product inventories are reportedly higher than last year.

- Euro-area woes and fiscal retrenchment will affect economic growth and oil demand in Europe.

Demand balance

OECD oil demand may contract, but this will be compensated by continuing increase in Asian demand supported by urbanisation, population growth and wealth creation.

Although it has some bottlenecks, most amply demonstrated by WTI, crude is priced internationally. Strong demand in Asian means high prices globally. From a financial perspective, energy commodity investment, and crude oil in particular, might be expected to outperform other forms of investment such as bonds or equities, for which performance is more regionally-based.

However, after years of high oil prices, the oil industry has expanded its capacity significantly, as shown by the extended boom in offshore rig building and the steady increase in the operational rig count. The turnaround in US onshore oil production is emblematic of this investment, exploiting not simply new finds but a new resource base -- shale oil -- the scope of which has yet to be assessed worldwide.

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