The year the world drowned in oil

JANUARY 2016

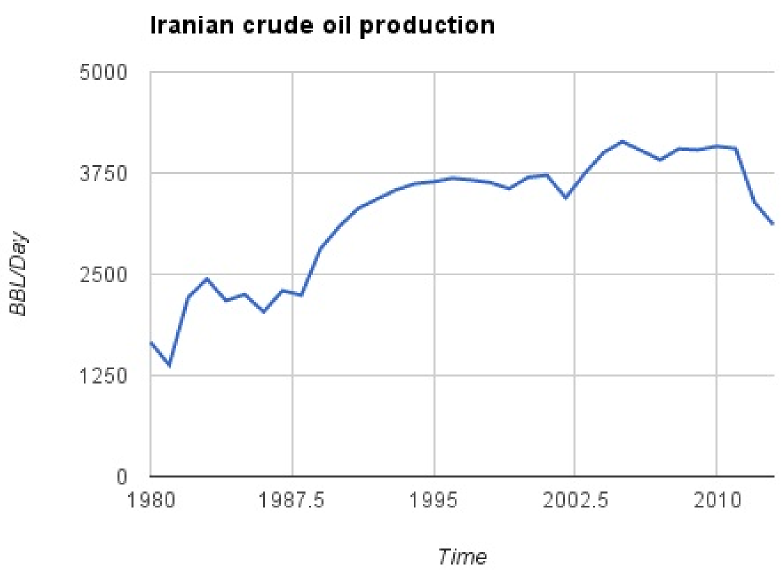
The international crude oil market is rarely stable and 2016 will not disappoint. Iranian crude oil returns to the international markets adding to the global oversupply while brimming US crude stockpiles is seriously testing storage limits. South Korea's freight rebate policy reform could potentially skew international oil pricing benchmarks while China's expected launch of a crude oil derivatives contract will challenge Brent and WTI benchmark status.

In the first quarter of 2016, Iranian crude oil is expected to return to international oil markets after the International Atomic Energy Agency (IAEA) verifies that Iran has complied with the Joint Comprehensive Plan of Action (JCPOA) to curb Iran's nuclear capability, signed 14 July.

Iran's crude oil exports currently stand at 1.10m bbl/day and production at 3.12m bbl/day, OPEC data shows. Iran believes it can raise production quickly, by 500,000 bbl/day, and incrementally add another 500,000 bbl/day by the end of the year. But before this flood of oil, there will be a tsunami wave that will hit the market first.

Since Europe raised sanctions against Iran in 2012 causing EU imports of Iranian oil to come to a complete halt, much of the excess crude oil produced since sanctions has been stored while production was drawn down.

The International Energy Agency estimates that Iran has 40m barrels of crude oil stored on vessels and these are set to sail as soon as the IAEA gives the green light.



Pressure on the benchmark

The first quarter could also see some potential downward pressure on the UK North Sea Forties Blend and the Dated BFOE benchmark and variants. This unintentional pressure is caused by the South Korean Energy Ministry, which has reformed its crude oil import freight rebate policy for importing non-Middle Eastern crude.

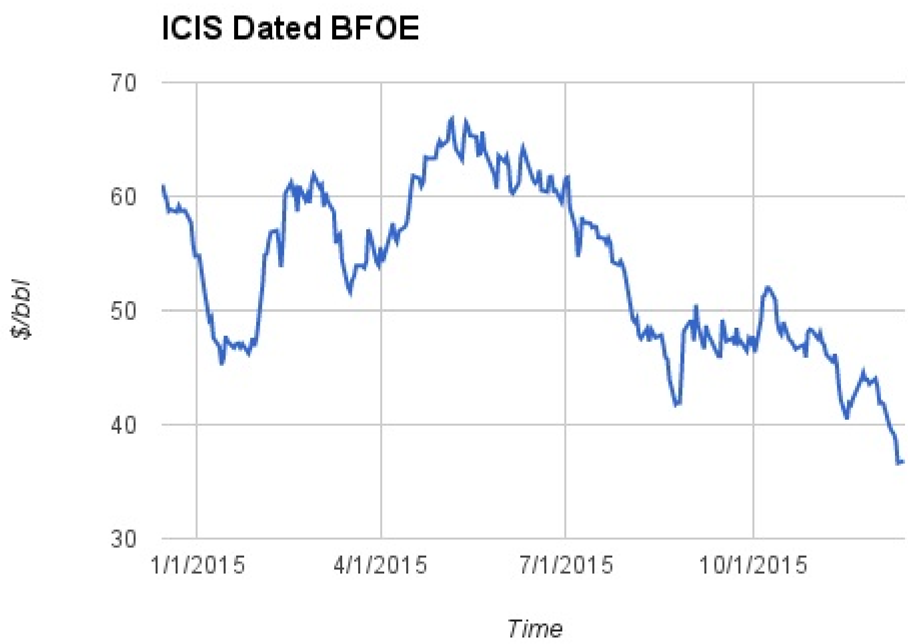
The freight rebate, designed to widen South Korea's sources of crude and shift away from the volatile Middle East, gave importers a rebate on the freight difference. However from early 2016 the programme will exclude spot deals favouring the security of term deals only.

South Korea has developed a taste for Forties. According to GAC shipbrokers, South Korea imports around 2.00-6.00m barrels/month, equating to three to 10 cargoes/month since 2012 when exports to South Korea began.

If South Korean demand disappears, this could not only put pressure on the value of Forties but potentially pressure the benchmark because the daily value of Forties is almost the de facto physical grade used in the daily benchmark calculation for around 70% of all physical crude oils.

The benchmark calculation picks the cheapest of the Brent, Forties, Oseberg and Ekofisk as part of the benchmark calculation and it is usually Forties because of its relative poorer quality. Additionally, the quality of Forties itself is also deteriorating with a rising amount of sulphuric Buzzard crude in the blend, according to BP data.

Forties is a blend of crude oils from different oilfields and the largest contributor is the Nexen-operated Buzzard oil field, which has made Forties increasingly sulphuric since 2007 when it was added to the blend. Nexen is a subsidiary of China National Offshore Oil Corporation.



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China goes international

Later in the year, China's national currency, the renminbi, will become more international as it enters the International Monetary Fund's (IMF) Special Drawing Rights (SDR) basket of currencies, which includes the US dollar, the euro, the British Pound and the Japanese Yen.

The SDR is an international reserve asset defined and maintained by the IMF. Members can buy and sell SDRs in return for freely usable currencies of IMF members and can be used to provide liquidity to governments and major institutions in exceptional circumstances such as the 2009 financial crisis.

The addition of the Renminbi into the SDR basket in September may roughly coincide with the launch of the long delayed crude oil derivatives contract planned by the Shanghai International Energy Exchange (INE), which sources say are close to finalising the product.

The Shanghai Crude oil futures contract will be renminbi-denominated and fully open to the International market. Their initial year is likely to see the contract dominated by Chinese domestic refiners for hedging purposes.

Overtime it is expected that the contract will eventually win a significant portion of the trillion dollar crude oil futures market away from the incumbents ICE Brent and NYMEX WTI simply because China is now the largest importer of crude oil, petroleum products and other liquids since September 2013, according to data from the Energy Information Administration (EIA).

Supply volatility

The 2016 story is inevitably going to be oversupply, but the effect on pricing is selective due to differing crude oil qualities. Iran's crude oil is mostly sour, much like Russia's with similar export destinations, where one is the Mediterranean/southern Europe.

Sanctions against Iran benefitted Russia's Urals and narrowed the price spread against the better quality light-sweet grades such as Algeria's Saharan Blend and on occasion even surpassed its value. The spread will widen next year and sour crude exports to southern Europe will be a buyers' market, while lighter grades in the region will at least sustain some strength due to its higher quality.

But there is an unpredictable source of volatile light-sweet crude that could return from war torn Libya where production was last heard quoted by the Libyan National Oil Corporation (NOC) at 375,000 bbl/day, well below its pre-civil war levels at 1.60m bbl/day. The rival government's latest agreement will see both sides form a unity government and have elections within two years, but the fighting goes on and now also with the Islamic State.

The global oil market may also see a stable source of crude oil from the US which cannot export domestically produced oil and only tiny volumes of non-US oil under the Energy Policy and Conservation Act 1975. The reasons for reversing the export ban are mounting, literally, as the US is seriously running out of storage space and hitting record high stockpiles in April.

Although the story is oversupply, there is fear that the worsening conflict in Yemen could spill over to Bab Al Mandeb, the strait where around 4.00m bbl/day of oil flows, potentially cutting this supply to the market, which will more than wipe out Iran's renewed contribution.

Decommissioning brought forward

The flood of crude oil from OPEC producers has forced US shale oil producers to cut back production. According to data from the EIA, US shale oil production fell each month since February as production remains uneconomical.

Although some US shale oil producers can return to production once oil prices are more favourable, for some mature regions such as the North Sea, the low oil price is already pushing producers to bring forward decommissioning plans, according to the UK lobbyist group, Oil and Gas UK (OGUK).
Bringing forward decommissioning plans in the North Sea will forever shut out a supply of crude oil because the oil cannot be produced even if prices recover since the infrastructure for production would have been removed already and at immense cost.

Decommissioning the UK North Sea over the next 10 years will cost around £17bn to scrap 79 platforms and plugging 1,200 oil wells, according to OGUK.

The US Gulf of Mexico, which provides around 25% of total US conventional crude oil production, is also facing a similar situation where high production costs are forcing producers to bring forward decommissioning plans forever shutting another source of oil supply even if prices recover to the point where production is profitable.

Conclusion

Looking back to 2016 from the future may indicate the year when the oil market began to fundamentally change.

The likely launch of a Chinese crude oil benchmark and China's entry in the SDR basket is a major crack in the US dollar hegemony over the crude oil market and also numerous commodities and political strength. After all, US sanctions against Iran and others would have been largely ineffective if Iran could fall back on another dominant currency to sell its natural resources.

After US and Europe raised sanctions against Russia over the annexation of the Crimea region, the pipeline deals struck with China and the oil and gas to be sold was already denominated in a mixture of renminbi and Russia's rouble.

The US central bank's plans to raise its federal funds rate and therefore the interest rate gradually in 2016 and the European Central Bank plans to loosen its monetary policy puts both banks in opposite paths as the US dollar will strengthen while the euro will weaken.

The ECB's fight against deflationary pressures is an attempt to inflate away its high levels of debt, but the fight will be ineffective since the crude oil oversupply is reducing global transportation costs and also the manufacturing cost base. The fight against deflation is really a fight against oil supply.

However, the above are just knowns and rarely a year has passed without some surprises in the oil market that could overturn the supply story to one of a shortage. Only time will tell.

After all, 2015 was the year when conflict in the Middle East increased, while oil prices fell, showing we are already in new territory.

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Easton House, Church Street, Easton on the Hill, Stamford, Lincolnshire, PE9 3NZ.

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