

Why oil prices went down so far so fast

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The reasons oil prices started sliding in June were hiding in plain sight - growth in US production, sputtering demand from Europe and China, and Mideast violence that threatened to disrupt supplies and never did.

After three-and-a-half months of slow decline, the tipping point for a steeper drop came on Oct 1, said Ray Carbone, president of broker Paramount Options Inc. That's when Saudi Arabia cut prices for its biggest customers. The move signalled that the world's largest exporter would rather defend its market share than prop up prices.

"That, for me, was the giveaway," Carbone said in an Oct 28 phone interview from his New York office. "Once it started going, it was relentless."

The 29 percent drop since June of the international price caught traders and forecasters by surprise. After a steady buildup of supply and weakening demand, the outbreak of an Opec price war is casting doubt on investments in new oil resources while helping the global economy, keeping inflation in check and giving motorists a break at the pump.

Brent crude, the global benchmark, declined to US\$82.60 (RM271.74) a barrel on Oct 16, the lowest in almost four years, from US\$115.71 on June 19. In the US, West Texas Intermediate touched US\$79.44 on Oct 27, the lowest since June 2012. US regular unleaded gasoline is averaging close to a four-year low of US\$3.01 a gallon nationwide, according to AAA.

The bear market exceeded the decline anticipated in exchange-traded futures, used by producers to hedge price swings. As recently as a month ago, Brent for delivery in November traded at US\$94.67 a barrel, 10 percent above the current price.

Opec secretary general Abdalla el-Badri denied the existence of a price war. "Our countries are following the market," he said yesterday at the Oil & Money conference in London. "People are selling according to the market price."

Officials from the Saudi oil ministry could not be reached for comment after hours.

Prices stayed higher earlier this year as traders focused on the risk that armed conflicts in Libya, Iraq and Ukraine could interfere with oil production, according to Jeff Grossman, president of New York-based BRG Brokerage. The disruptions never materialised.

"This one caught a few people off guard because they were still worried about some of these geopolitical things that were happening all over the world that never came to fruition," said Grossman, a New York Mercantile Exchange floor trader. "We probably never

should have been over US\$100.”

Libya's output

Libya's production tripled since June to about 900,000 barrels a day, still 40 percent lower than two years ago, according to an official with direct knowledge of the matter. War hasn't stopped production in Iraq, which is pumping 3.1 million barrels a day, within 10 percent of February's 13-year high. The Organisation of Petroleum Exporting Countries (Opec) boosted September production to an 11-month high of 30.9 million barrels a day.

London-based Barclays Plc cut its oil-price forecasts on Oct 28 for the second time this month, citing a global surplus. Brent will average US\$93 a barrel in 2015, while WTI averages US\$85, down from previous estimates of US\$96 and US\$89, respectively, the bank said.

The revision follows Goldman Sachs Group Inc cutting its 2015 forecasts a day earlier, to US\$85 a barrel from \$100 for Brent, and to US\$75 a barrel from \$90 for WTI. Brent will average US\$99.65 a barrel in 2015, down from a September prediction of US\$105.50, according to the average of 46 analyst estimates compiled by Bloomberg.

Oil ShaleOpec faces increasing competition from the US, where technological breakthroughs - hydraulic fracturing and horizontal drilling - have enabled domestic production to replace imports at a historic pace. Output surged 14 percent in the past year to 8.97 million barrels a day, the highest since the US Energy Information Administration's weekly estimates began in 1982.

Yet US production has been booming for years now without setting off a bear market, said Katherine Spector, an analyst at CIBC World Markets Corp. What changed this summer was macroeconomic data indicating weak demand in Europe and Asia, she said in an Oct 16 report.

The International Monetary fund this month cut its forecasts for global growth in 2015 to 3.8 percent from 4 percent. The Paris-based International Energy Agency predicted world oil consumption would expand at the slowest pace since 2009 after cutting its forecast in October for the fourth time in a row, to half what it predicted in June.

On Oct 1, Saudi Arabia lowered prices on its crude exports to Asia to the lowest in more than five years. Iraq and Iran followed. Frankfurt-based Commerzbank AG called it a price war.

“That's where the perception of their action changed overnight,” said Ole Hansen, head of commodity strategy at Saxo Bank A/S in Copenhagen. “They must have been aware how the market would interpret that when they'd been such a guarantor of stable prices for so long.”

Brent crude for December settlement fell 1.3 percent to US\$86.01 a barrel on the ICE

Futures Europe exchange as of 4.15pm in New York. West Texas Intermediate lost 1.5 percent to US\$80.97.

The plunge does not accurately reflect the balance between oil supply and demand, Opec's El-Badri said at the London conference yesterday.

Growing demand

"We see that demand is still growing, that supply is also growing, but the magnitude in the increase in supply does not really reflect this 25 percent change in the market," he said. "Unfortunately, everybody is panicking."

As Saudi Arabia tolerates lower prices to protect its market share, the kingdom is also testing the level at which higher-cost US production remains profitable, according to the IEA. As much as 50 percent of shale oil is uneconomic at current prices, El-Badri said. New York-based Sanford C Bernstein & Co estimates about a third of US production from shale loses money at US\$80 a barrel.

"We think there's a lot of economic oil at US\$75, economic meaning we earn 15 percent, 16 percent, 17 percent returns," Stephen Chazen, chief executive officer of Houston-based Occidental Petroleum Corp, said during a conference call with analysts Oct 23.

Other US drillers have already altered plans due to lower prices.

ConocoPhillips today became the first major oil company to announce plans to reduce spending in emerging oil regions such as West Texas and the Rocky Mountains. Dallas-based Exco Resources Inc will defer some drilling in North Louisiana because of lower prices, president Harold Hickey said on a conference call yesterday.

"We've used US\$100 Brent as the basis for our plans even as Brent has averaged nearly US\$110 for the last three years," John Hess, New York-based Hess Corp's billionaire CEO, said on a conference call yesterday. "However, with Brent now at approximately US\$87 per barrel, we are reviewing our plans and actions that we might take in a lower price environment."

Al Walker, chairperson and CEO of The Woodlands, Texas-based Anadarko Petroleum Corp, said on a conference call yesterday that the company will "watch this for a few more months and when we announce our capital plans in March, we'll have a much better idea of what we expect".

Consumers, on the other hand, have cause to celebrate. A 20 percent drop from the average oil price of the past three years amounts to a US\$1.1 trillion annual stimulus to the world economy, Citigroup Inc estimates. In the US, gasoline continuing at the current level would add 0.4 percent to annual economic growth, according to Joseph LaVorgna, New York-based chief US economist at Deutsche Bank Securities Inc.

“Historically, when price changes kick in, they are usually more violent than the forecasts,” said Torbjoern Kjrus, senior oil market analyst at DNB ASA in Oslo. “It’s difficult for analysts to see such a massive drop, as you will look like a conspiracy theorist.”

Some analysts do, however, see a price rebound. Brent will climb to as much as US\$100 a barrel next year, according to London-based Standard Chartered Plc, Sanford C Bernstein and Barclays.

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