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The Oil Patch

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Oil consolidates on demand lift and slow investment response:

Consensus around rising global oil demand in response to economic growth has enabled oil prices to consolidate last year's gains and trade in a $US60-$US65/bbl range.

But a hot debate on where global supply is headed means a divide exists on where to next for global prices.

As it was, the period between mid-February and mid-March saw global prices regain some lost ground.

WTI climbed from $US60.77/bbl to $US61.18/bbl by mid-March. While lower than in prices in mid-January of $US63.73/bbl, WTI currently sits more than 20% higher than last year's annual average of around $US50/bbl.

Brent rose from mid-February's $64.42/bbl to $US65.05/bbl, again up strongly on last year's annual average of $US54/bbl.

While the $US70/bbl level for Brent seen in January has not returned, the ability of the global benchmark to consolidate in the mid $US60/bbl range is a confidence boost for the oil patch given the recent turmoil in equity markets.

The turmoil – the sharp but short sell off in February was triggered by inflation and rising interest rate fears – took its toll on equity values in the oil patch, with most ASX-listed stocks trading lower by mid-March.

Despite the equity weakness, the local sector remains at its most buoyant in three years in terms of exploration and development activity, with a bit of merger and acquisition activity thrown in for good measure.

Still, a step up in industry activity in response to oil's recovery from last June's shell-shocked $US43/bbl level (WTI) will be needed to meet future demand.

Higher prices needed to lift discovery rates:

In its recent five-year outlook study, the International Energy Agency highlighted that oil discoveries in 2017 were at a record low of 4 billion barrels compared with the 36bn barrels consumed in the year.

And while the price recovery to near three- year highs has seen the global industry step up exploration and development activities, the big question remains – is it enough?

The IEA noted that 2018 investment spending was likely to grow by "only" 6% after having barely increased at all in 2017.

And while production increases from non-OPEC countries to 2020 are by themselves expected to be enough to meet demand growth, things aren't so certain in later years.

"After that time (2020), the pace of growth from these countries is less certain, and the market might well need the supplies currently being held off the market by leading producers,'' the IEA said.

OPEC has also pointed to supply shortages in the absence of a major step up in exploration and development spending.

Analysts at investment bank Citi are not so sure. "OPEC and IEA analysts appear to underestimate the huge growth in capital efficiency in the upstream since 2014,'' Citi said. It added that OPEC specifically looks to be overstating the acceleration of oilfield decline rates globally.

"Saudi officials in particular have talked about 3.5-5% annual declines that appear to be growing due to the capex slowdown, pointing to 20-30 million barrels of oil a day of lost production over the next half decade. This aggressive position on declines looks vastly overstated,'' Citi said.

OPEC issues the big factor in supply problems:

While the supply debate rages on, the IEA in its latest monthly update (March 15) said there were clear signs that supply and demand were more closely "aligned.''

It pointed to OECD stocks falling close to average levels, and the forward price curve's move in to backwardation at "prices that increasingly appear to be sustainable.''

On the assumption that OPEC production remains flat for the rest of 2018, there was a "very small stock build" in the first quarter, with deficits forecasts for the rest of the year.

But then comes the production shortfalls within OPEC, with Venezuela's dramatic production declines in recent times emerging as a hot issue.

"With supply from Venezuela clearly vulnerable to an accelerated decline, and without any compensatory change from other producers, it is possible that the Latin American country could be the final element that tips the market decisively into deficit,'' the IEA said.

It is a theme that Citi had no qualms with, at least in the longer term.

"If the age of abundance has a supply problem, it looks less likely to be coming from lack of investment in non-OPEC oil and more likely to be centred on OPEC, where limited investment in Iran, Iraq, Nigeria, Libya, Venezuela, Angola and the smaller producers could be a major concern in the next five years,'' Citi said.

Oil production from Venezuela has been on the skids for the past two years. It produced 2.3m barrels-a-day in January 2016 but could only manage 1.6m bopd in January this year.

The US Energy Information Agency blames the fall on a combination of relatively low global oil prices, and the mismanagement of Venezuela's oil industry.

"Several factors indicate that Venezuela's crude oil production will likely continue to decline. The number of active rigs has fallen from near 70 in the first quarter of 2016 to an average of 43 in the last quarter of 2017,'' the EIA noted.

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