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The Oil Patch

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Oil shrugs off OPEC increase and trade war threat

Normally an increase in OPEC production is a negative for the oil price. The same goes for when the global economy is threatened by a trade war.

But things have not panned out that way, with oil prices managing to edge higher in the last month despite the emergence of two “normal’’ negatives.

While price volatility increased, Brent rose from $US73.44/bbl to $US75.33/bbl, and WTI climbed from $US65.06/bbl to $US71.01/bbl.

The gains were despite OPEC’s and Russia’s June 22 agreement to increase production in light of the recovery in prices to three year highs, and the accord’s success in reducing the glut in oil stocks.

The increase – estimated at about 600,000 bopd – is to be achieved by moving to 100% compliance with the original November 2017 production restraint accord, making it something of a Claytons increase.

Compliance ahead of the June 22 meeting was actually running at 152%, due mainly to the well-known production shortcomings in Venezuela (down 50% on 2017 levels).

So, the June 22 decision is a neat outcome for OPEC in that it can increase output without breaking the November 2017 restraint agreement, sort of anyway.

A bigger challenge to oil holding on to its “7” handle is the potential for a full-blown trade war between the United States and China.

Most recently the US has threatened to impose 10% tariffs on $US200bn of Chinese products on top of the existing tariffs of $50bn. China has come back with its own threats, including sanctions on US oil and LNG.

But as noted earlier, neither the OPEC increase in output, or the threat of a US-China trade war, has derailed oil’s price recovery.

Supply cushion fears

A key factor in oil’s ability to shake off the price negatives has been concerns that the market has become more susceptible to supply disruption risk.

In its latest oil market report, the International Energy Agency said that the fact that oil prices have remained relatively high reflects various supply concerns.

Apart from Venezuela’s effective breakdown, the IEA is worried about the US push for renewed oil sanctions on Iran, and Libya’s ability to overcome recent attacks on its oil infrastructure.

“Some of these supply issues are likely to be resolved, but the large number of disruptions reminds us of the pressure on global oil supply. This will become an even bigger issue as rising production from Middle East Gulf countries and Russia, welcome though it is, comes at the expense of the world’s spare capacity cushion, which might be stretched to the limit,’’ the IEA said.

"This vulnerability currently underpins oil prices and seems likely to continue doing so. We see no sign of higher production from elsewhere that might ease fears of market tightness.''

The commodities desk at investment bank Citi agrees supply disruption risk is a bullish factor for oil prices. It adds the potential for the US hurricane season to have an impact on exports at a time of rising importance of US supplies to global markets.

US oil production is forecast to eclipse the previous record of 9.6mb/d in 1970 by reaching 10.8mb/d annual in 2018 and 11.8mb/d in 2019, based on forecasts by the US Energy Information Administration.

Making boom time margins

Match up the benefits of oil's recovery to the radical cost cutting that followed the 2014 price collapse and the oil producers are once again enjoying bumper margins flowing through to their bottom line.

So much so that industry consultant Wood Mackenzie estimates that upstream cash margins at the current $US75/bbl oil price are actually 65% higher than when the industry was fat and lazy in 2012 with $US112/bbl oil.

Thanks to free cash flow break evens being reset to $US50/bbl to cope with low prices, the improvement in oil prices from the low of $US46.53/bbl in July last year sets the industry up for a $US160 billion annual cash windfall.

It raises the question of what will the oil companies do with the windfall. Wood Mackenzie suggested greater shareholder returns in the first instance, and then increased merger & acquisition activity.

It also suggested increased sustaining investment was required to beef up the pipeline of future projects that meet two criteria – make money at low prices, and leverage to commodity price upside.

It's a gas for Australia

Rising gas prices and concerns about near-term supply shortages has made the Australian domestic gas scene something of a political hot potato.

But there is something to celebrate – the surge in the value of LNG exports as a result of eight LNG projects being built in the last 10 years, and the recent recovery in global LNG pricing.

The Federal government's Office of the Chief Economist now forecasts that the value of LNG exports will surge from $30.8 billion in 2017-2018 to $42.4 billion in 2019-20, firmly establishing LNG as the nation's number two export behind iron ore.

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