Le dernier mot

With oil having inched up to US$40/bbl, the days of US$100/bbl plus seem a distant memory. But the current prices are not sustainable, and producers continue to suffer. Is this the new normal? asks Jean-François Lambert

We left the era of oil price secular stability in June 2014. Markets have gone in a single direction – south.

The beginning of 2016 confirmed the trend with Brent around US$35/bbl. Doom and Gloom doctors are predicting US$20/bbl, and even US$15/bbl and, these days, D&G doctors have been known to be more right than wrong.

But is that it? What happens next when the markets have done being bearish? Is it back to the old days of around US$110/bbl? Very few believe this. Since I have already started to make a fool of myself (going in print about the oil price is a tad risky), I would like to take a slightly different route in this column and explain what I believe will be the new normal of oil for the next few years.

My theory is that oil prices will be fluctuating in a rather tight corridor for quite a few years. As it stands, once markets have found their lows (soon), prices should hover between US$35/bbl and US$50/bbl. I admit that oil prices could venture below US$35/bbl with Iran and Iraq ramping up their output, for instance. But I do not believe this would or could last very long.

This assumption is based on three arguments:

- a slow growth era is setting in on the world;
- shale oil producers' dynamics; and
- the old peak oil issue.

Slow growth?

According to forecasts, the global economy is expected to grow at 3.1% in 2016 (IMF) and 3% in 2017 (HSBC). This is not a bad thing in the long run, for it suggests that at this rate, the world economy would double in less than 25 years; nevertheless, the world is decelerating, particularly in emerging markets.

What does all this mean for oil? I think that while oil demand will continue to grow, it will do so at a slower pace. Any surge in demand is therefore unlikely at least for a few years.

Shale oil

Alongside the slow growth, supply is increasing – mainly from the US shale producers. Although historically declining, US oil production, thanks to shale, almost doubled in the past three years adding a stunning five million barrels of oil per day – almost half the Saudi output.

Shale oil producers (SOPs) have a very different dynamic than conventional ones. Traditionally, producers are facing huge capital expenditure (think North Sea oil rigs), and relatively low operating expenditure (pumping mainly). In the shale oil world, it is the opposite. Cost lies in the actual fracking (chemical and high pressure water injection,), and less in the drilling. This means it is relatively easy for SOPs to mothball rigs if price is not adequate. Conversely, when price is right, resuming production is very simple.

In other words, SOPs have become the new swing producers. At the right price, they will produce swiftly and stop whenever demand/supply balance pushes the prices below their costs.

In effect this creates a mechanical ceiling on price.

Peak oil?

Nobody talks about peak oil anymore. Yet the concept is enduring if only properly understood. Peak oil is not about the absolute amount of known available reserves on earth, but about their level at a given price. Here is an example: at US$125/bbl, the amount of viable reserves in the world is 1,455 billion barrels (bb). At US$40/bbl, it tumbles to 561bb. And at US$20, viable reserves equates to merely 339bb . This tells you that the current level of prices is simply not sustainable.

Consequences

What this all means is that too low a price too long combined with the peak oil effect will mechanically push prices up. Above US$45-US$50/bbl, the shale oil producers will resume production and boost the overall supply, derailing the fragile supply/demand equilibrium. Oil in the current economic environment is therefore bound to fluctuate in a relatively tight band.

What does this mean for commodity financing? Producers will continue to suffer and will rely more on their trading partners. So expect more structuring around shorter flows, with hedging becoming a core feature of financing. Traders are well aware of this. Will bankers follow? As regulators are focused on commodity risks, this is by no means guaranteed.

Jean-François Lambert is a consultant on commodity finance. He is the former global head of commodity finance and structured finance at HSBC and can be contacted at jflccf@yahoo.com

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