



## 1.1m

Reduction of barrels per day in global oil forecast (IEA)

## 9.7m bpd

cuts agreed by OPEC+ over Easter

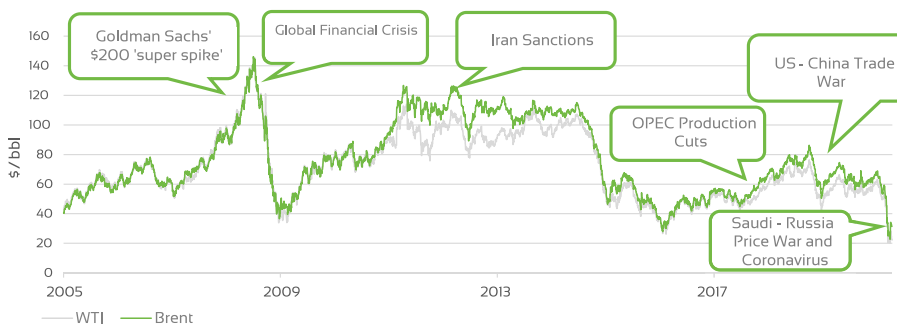
## Oil Overview: Cartels, price wars and COVID-19

### Overview

Crude oil is a raw commodity that is refined to produce usable products such as petrol, diesel, and other petrochemicals. The two major crude oil benchmarks, referred to by market participants, are Brent Crude and WTI (West Texas Intermediate). These represent different types of crude oil based on geography and quality, with Brent referring to oil produced in the North Sea, and WTI being produced in the US. Oil is a global market and these two benchmarks are relatively interchangeable which means that they tend to trade with a narrow spread.

Oil prices are a key indicator for the state of the global economy. Economic productivity, both in the production of goods and transport activity (air, road and sea), leads to growing demand for oil and therefore higher prices. When demand drops during recessions, oil prices tend to follow. Figure 1 illustrates the key demand-related events, over the 15 years, that have impacted oil prices.

Figure 1: Brent and WTI Closing Prices 2005-2020



### OPEC & OPEC+

The Organisation of the Petroleum Exporting Countries is an inter-governmental body formed in 1960. According to OPEC, the objective of the organisation is to coordinate petroleum policies, stabilise oil markets, ensure regular supply, safeguard income for producers and ensure fair return to investors. Figure 2 demonstrates current OPEC member states.

### Quick facts

The two major crude oil benchmarks, referred to by market participants, are Brent Crude and WTI (West Texas Intermediate).

OPEC+ decided to meet again last week and agreed to production cuts of 9.7 million barrels per day.

In March, oil prices suffered their sharpest decline since the 1991 Gulf War as the OPEC+ alliance broke down.

COVID-19 first began to impact Oil prices at the end of January, when China effectively shut down its economy.

It is important to consider that each member state has its own objectives. For example, less economically developed members often support supply control to maximise revenue. On the other hand, for more developed members, such as Saudi Arabia, maintaining market share and keeping prices competitive are key. If oil becomes too expensive, alternatives will be found. In 1973, Saudi Arabia's oil minister famously said, 'The Stone Age didn't end because we ran out of stones.'

**Fig 2: World map with OPEC member states shaded blue**



As oil production from non-OPEC countries, such as Russia and the US, increased, the fight for market share meant OPEC quotas were regularly being breached. US oil production has doubled from 2008, due to the shale oil boom, making the US the world's largest producer and leading to a global oil glut.

In 2017, to prevent further oversupply and price decreases, a production cut of 1 million bbl/day was agreed between OPEC and 10 non-member states, including Russia. The alliance is often referred to as OPEC+. Further cuts have been agreed by OPEC+ since 2017.

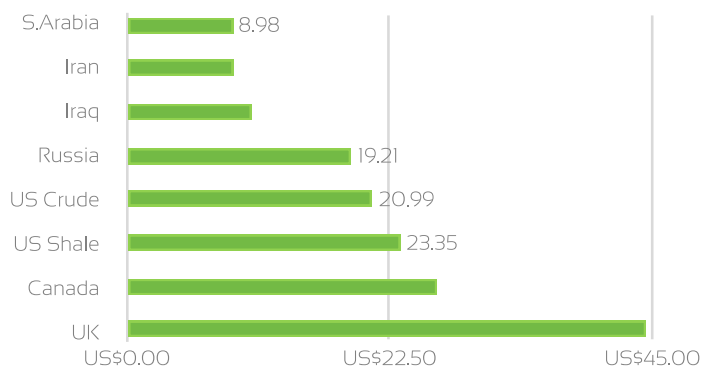


## A cartel that excludes the world's largest producer?

Many economists argue that OPEC is a textbook example of a cartel as members cooperate to reduce competition and control prices. So how is this legal? Put simply, the operation of cartels is usually outlawed by governments to protect consumer rights, OPEC is made up of members of government.

The US government has often found itself frustrated by the actions of OPEC. When OPEC cuts kept oil prices above \$70/bbl in 2018, the US were concerned that the higher price benefit to shale producers was being outweighed by damage to the US economy. Conversely, as WTI prices currently sit in the region of \$20/bbl, concerns have arisen over the economic feasibility of, more expensive, US oil production. Figure 3 demonstrates the cost of producing oil for various oil producing countries.

**Fig 3: Oil production costs USD per bbl including capital spending, taxes and admin/transport costs**



## March 2020 Price War

December 2019 saw OPEC+ agree to its largest ever production cuts, around 1.7 million bpd. Russia, however, failed to agree to extended and deepened cuts, in March 2020, due to market share concerns with the US. As a result, the OPEC+ partnership broke down.

A price war ensued as Saudi Arabia decided to increase their output significantly to maintain market share. Oil prices suffered their sharpest decline since the 1991 gulf war.

This increased production, and COVID-19 induced global demand suppression, saw producers rush to store oil that could be sold later when prices improve; a tactic known as contango play, usually performed by trading houses. With terrestrial storage filling up fast, many producers turned to supertankers (capacity >2mil/bbl) for floating storage. The rush for ships saw daily rates soar to over \$120,000/day from around \$40,000/day. Unsurprisingly, share prices for shipping companies jumped.

As oil prices continued to decline, at one point reaching their lowest since November 2002, OPEC+ decided to meet again over Easter and agreed to production cuts of 9.7 million barrels per day. Some market analysts question whether these cuts, even if backed by US cuts, would be enough to rebalance the oil markets amid COVID-19.

## COVID-19

COVID-19 first began to impact Oil prices at the end of January, when China effectively shut down its economy to protect against large scale transmission of the virus.

With similar mitigation activities rippling through the rest of the world throughout February and March, Oil prices continued to decline, with weakening prices only exacerbated further by the March price war.

The International Energy Agency (IEA) has reduced its 2020 base case forecast for global oil demand by 1.1 million barrels per day (mb/d). Although China is expected to resume relatively normal economic activity in April, labour shortages and supply chain disruption mean that it will take some time to achieve productivity levels of pre-COVID-19. With containment efforts in Europe and North America moving even slower, we expect the impact of COVID-19 to sustain for much longer than just Q1 2020.

We expect that it will be at least Q3 2020 when we start to get signs of a return to normal economic activity, which should coincide with a slow rally of oil prices.

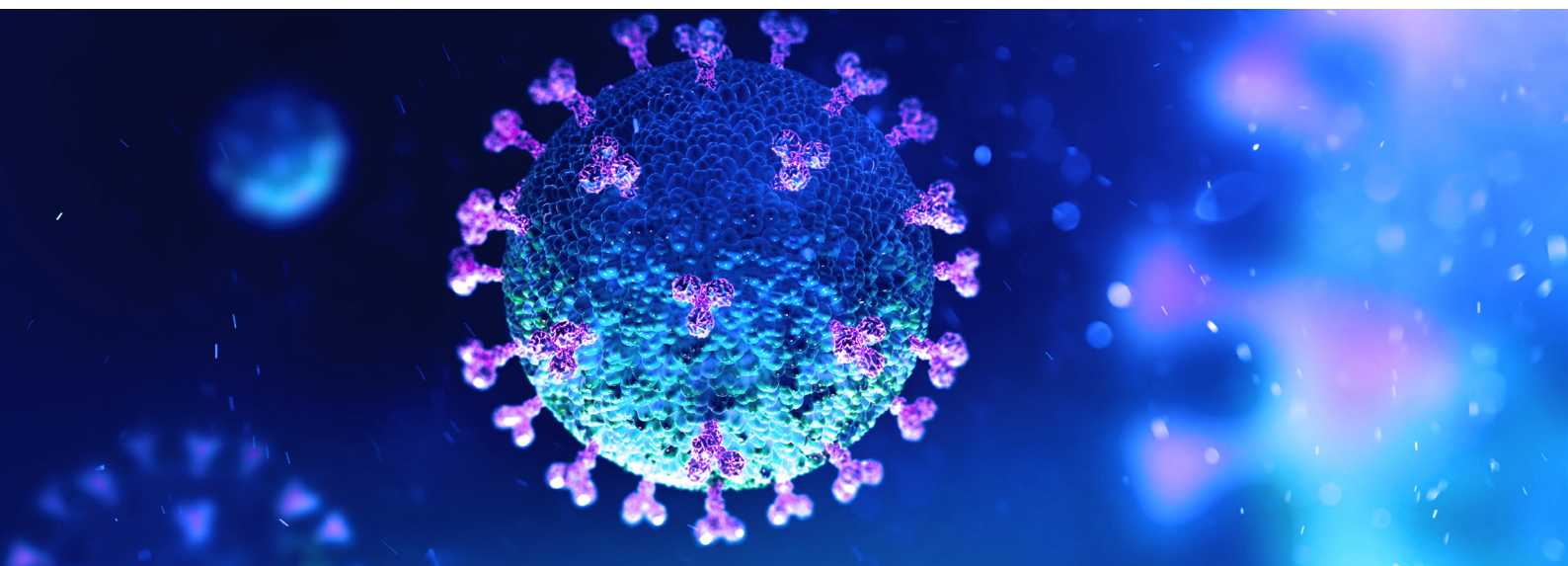
## How are UK Gas & Power markets being affected?

Whilst oil and gas markets were historically indexed closely, in recent years we've seen a move to hub-based pricing, however, sentiment from rising or falling oil prices still affects gas and thus power markets.

Oil is typically a long-term market driver, therefore, market movements resulting from changes to oil prices are more visible on further dated contracts, rather than contracts for delivery in the shorter-term or prompt contracts.

In recent weeks, seasonal gas and power prices appear to have been driven significantly by oil prices. Prices have steadily declined since January, but dramatic decreases were seen throughout March as the Saudi-Russia price war rumbled on and COVID-19 induced demand destruction continued to pressure oil prices.

Oil prices have further weakened throughout April as global demand continues to dwindle and storage is quickly filling. Some analysts expect US storage to be full in 2 weeks. Yesterday saw WTI front month prices fall below \$0 as traders looked to offload unwanted oil before the contract expired and they would be forced to take delivery of the commodity.



If you require any further information on the topic discussed in this month's publication, or if you have any questions, please get in touch with Optimised Energy's Trading and Risk Management Team at [markets@optimisedenergy.com](mailto:markets@optimisedenergy.com)

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