MARKET*MATTERS*

Oil Markets Undergo Departure From Normal

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Sustained crude oil production in the face of declining prices has introduced a new element into traditional thinking about price levels. Heretofore, analysts looked on the sharp price drop as a unique departure from normal. That is to say, prices might fall, even sharply, but eventually production would be shut in and surplus product would be consumed by demand at lower prices. The recovery in price would re-equilibrate at some level.

The current situation flies in the face of this pattern. Some producers have announced initiatives to deal with new production in a low price environment. Lower prices have led to reduced capital spending. Independent shale oil producers reportedly have cut drilling plans by $50 billion this year. Nonetheless, they expect to increase output by focusing on their most promising fields.

Producers could achieve this by strategies that allow them to pump more crude as prices start to rise. They would drill wells, but defer stimulation. This, in effect, would allow them to store oil in place and get to it rapidly in response to higher prices. This could tend to cap prices as well. One observer notes, "We are in slightly unexplored territory. It's a big, big experiment."

One producer reportedly is drilling 285 wells that will remain unfinished until crude oil prices recover to $60-$65. This thinking is becoming very common. Five large producers that have indicated interest in this strategy account for nearly 10 percent of U.S. crude oil production. There are reportedly at least 3,000 wells in Texas and North Dakota drilled, but not in production.

It is problematic whether the U.S. industry can adjust to changing prices rapidly enough to stabilize prices. It is one thing for a government such as Saudi Arabia–a single decision maker–to determine national output. It is quite another for the highly diverse set of producers that comprise the American producing industry to adapt their businesses to a single goal, or even to agree what that goal might be.

The increase in production and crude oil in storage has been remarkable. Markets absorbed another 4.5 million barrels of crude during the week ending March 6. This confirms the significantly oversupplied crude oil market that has been building since 2002-03, when crude oil supply bottomed slightly above 18 days of inventory. As of March 6, there were 29 days of crude oil in storage, a number not seen since March 1986 (Figure 1).

Refineries are operating at reduced turnaround levels and demand has been treading water slightly below 20 million barrels daily since 2008, despite lower product prices.

So much crude oil supply, at best tepid demand, and important strictures on crude oil exports should translate to significantly lower crude oil prices. Prices fell from $107.73 on June 20, 2014, to $43.58 on Jan. 29, 2015. The industry has added another 35.8 million barrels to supply since then. Prices, meanwhile, ended their downswing, trading between $47 and $54.

Industry press is replete with stories of swollen inventories, an observation at odds with the reality of narrow range trading for crude oil. One analyst wrote, "WTI could take another leg down. If there is enough distress, if imports don't budge, which they won't, if exports don't rise quickly enough, which is a wild card, then producers need to shut in pipelines or run at low utilization so it doesn't come to Cushing."

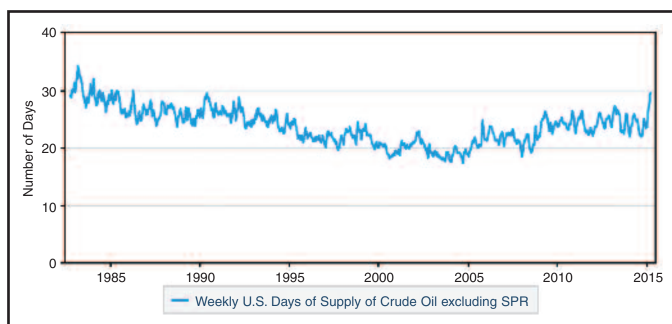
It is hard to explain why, in the face of so much bearish information, crude oil prices have not reached $40 (as of March 17), or even a price in the $20s, as predicted by one analyst. One possibility is the expectation that, as spring advances, demand will pick up and eat into the crude oil overhang.

Geopolitics may be at work, too. Negotiations with Iran over its nuclear program may not succeed, and the prospect of Iranian crude oil adding to supply may come up short. Moreover, the situation in Libya is very unstable. Loss of that supply could be supporting prices as well.

Meanwhile, the Energy Information Administration's *Short-Term Energy Outlook* confirms continuing high levels of natural gas production. Despite declining prices and rig counts, marketed production reached 78.8 billion cubic feet a day in December. EIA chalks up the anomaly to improving rig efficiency. Natural gas output rose 6.1 percent for all of 2014, which was the strongest growth since 2011.❒

FIGURE 1

Days of U.S. Crude Supply (Excluding SPR)



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