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The crude oil conundrum

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Crude oil is one of the most important, if not *the* single most important raw material input to all industrial activity. Considering this, it would be reasonable to assume that after more than 150 years of international trade, we would have a very firm, unwavering grasp on which factors have the most influence on oil prices, along with a very clear understanding of the timing and influence of these factors.

However, analysts are very divided on what the price of oil should be. Whereas one group of analysts (Facts Global Energy, Rystadt Energy, etc.) believe that crude oil prices will recover again to reach almost \$100/barrel by the end of the year, another equally credible group of analysts (JP Morgan, US Energy Information Administration “EIA”, etc.) have a markedly different view – they believe the oil price will fail to break through the \$80 mark.

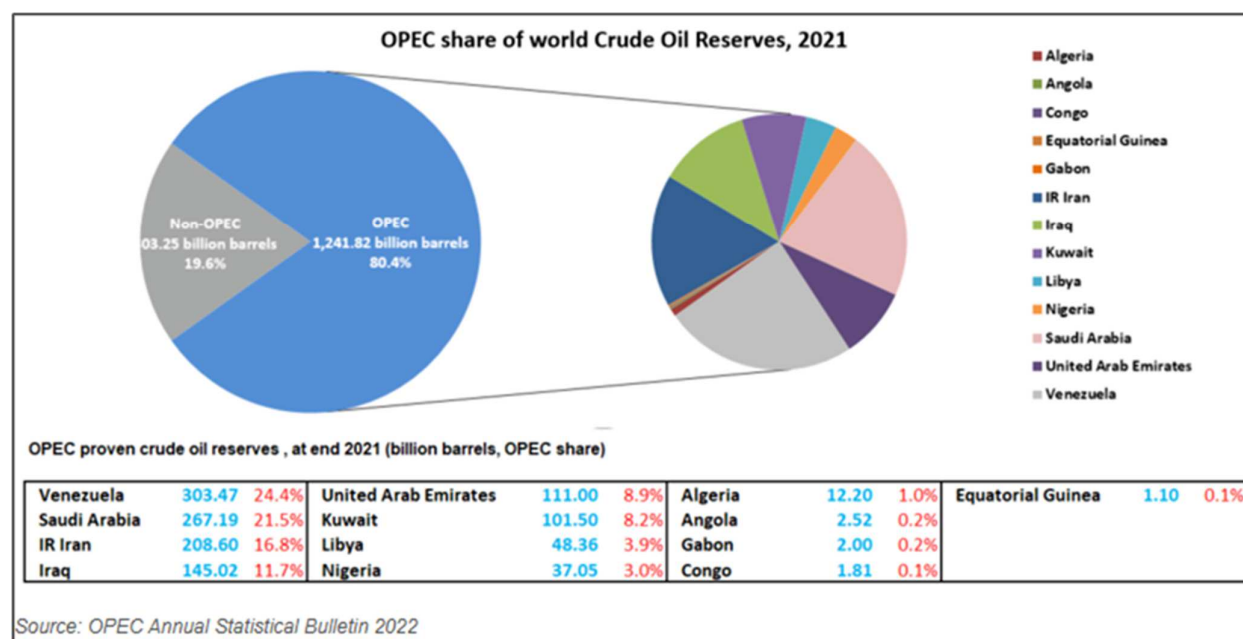
Given the importance of black gold, we seem rather unsure of what we should be paying for it. This article will consider the broad implications of oil price moves in the near and longer term, as well as discuss one possible method to benefit either way.

I do not intend, however, to add my voice to the plethora of others making (most likely incorrect) predictions about the price of Brent Crude come year end.

Synopsis:

For readers not familiar with the industry, it is worthwhile taking a brief step back in order to sketch the scenario.

Global oil supply, and as a result oil prices, is to a large extent controlled by the OPEC group – which effectively operates as a cartel. This has been the status quo for more than 7 decades since the creation of OPEC in 1960. The group currently has 13 members, almost all of whom are located in the Middle East and Africa with the exception of Venezuela. This alliance is so powerful, because between them, they control about 30% of the world's oil production, but they own a massive 80% of oil reserves – according to both the oil company British Petroleum (BP) and OPEC's internal estimates.



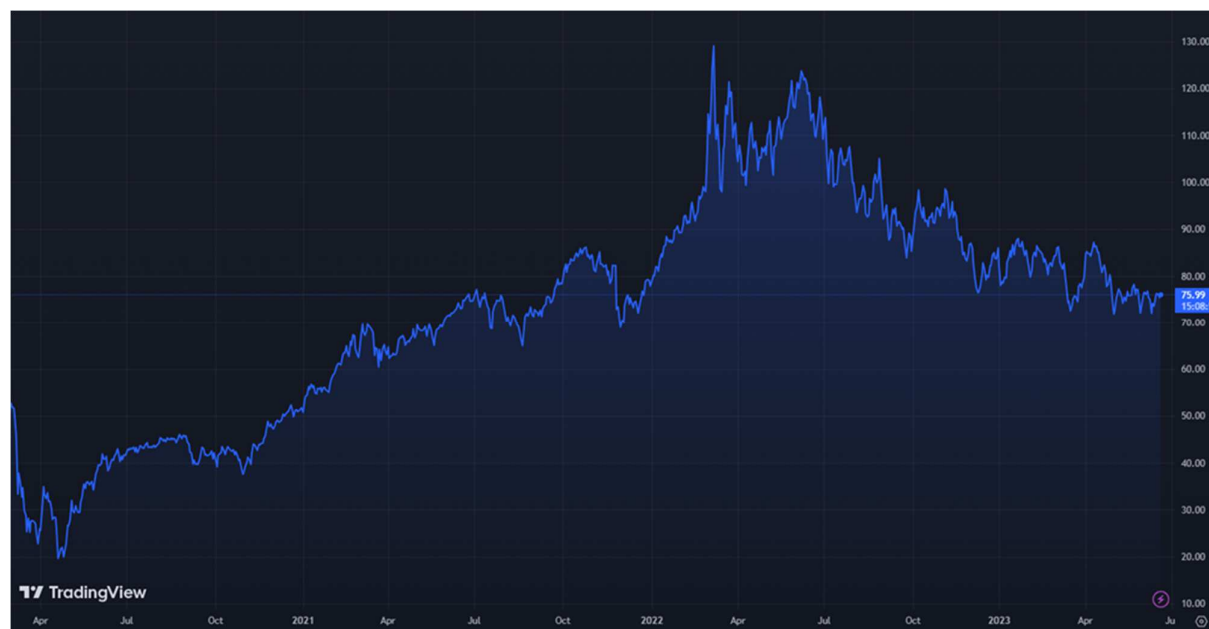
At about 35% of the total production, Saudi Arabia is by far the largest contributor to OPEC's output, more than double the size of 2nd placed Iraq. Given this dominant position, there is little doubt that Saudi Arabia has an outsized amount of control over decision making within OPEC. This was quite evident when assessing the actions of US President Joe Biden, travelling to Saudi Arabia to fist bump Saudi Crown Prince Mohammed Bin Salman – only a year after he said the kingdom should be treated like a pariah state due to its human rights record (which includes the assassination of critic-of-the-Kingdom journalist, Jamal Khashoggi - on the sovereign soil of another country). So, what might have been the reasons for the much-improved attitude towards the gulf state?

1. To try and improve relations.
2. In order to ask them to pump more oil.
3. Leading to lower gasoline prices for US citizens.
4. Which would boost midterm election performance.

There are 2 big takeaways here. The 1st being that despite all the shifting rhetoric to renewables, old fashioned fossil fuel is in no hurry to make a swift exit from the scene. The 2nd is that Saudi is a major cog in the global oil supply chain – and even more so within OPEC.

Glancing in the rear-view mirror

The price of Brent crude oil has been a roller coaster over the last 3 years. The Russian invasion of Ukraine in February last year sent it rocketing to an intra-day high of \$130/barrel, only to come crashing back down to low-\$70's/barrel at the time of writing. Not to mention the brief dip below \$0 for future contracts in April 2020 as demand collapsed during the pandemic.



This fluctuating price is not ideal for countries whose entire budget relies on the oil price. OPEC thus adjusts supply, within reason, whenever they feel the price is too low. This has happened on a number of occasions over the last couple of months:

- October 2022 – group-wide cuts of 2 million barrels per day.
- April 2023 – voluntary cuts by 8 OPEC members of 1.6 million barrels per day.
- June 2023 – Saudi Arabia further announces a further reduction of 1 million barrels per day – which comes into effect in July, and OPEC members agreed to extend earlier cuts.
- OPEC+ (a larger group including Russia), also announces it will reduce production by another 1.4 million barrels per day, starting 2024.

Global oil demand is roughly 100 million barrels per day, so in total, these cuts add up to almost 6% of global supply. On the opposite end, Russian oil - vital for financing their war effort - has continued to find a way into the market, mainly via Asian buyers. Data from Kpler Research indicates that Chinese imports of Russian crude averaged 1.59 million barrels per day in March 2023, up 68% from the same period in 2022. The result is that prices have perhaps not reacted as fast as OPEC would have liked, but at some point, they must. Once recessionary fears abate and when (if) Chinese manufacturing numbers finally ramp up, the normal economic principle of demand outweighing supply, leading to rising prices, must prevail.

After the April cuts, the International Energy Agency “IEA”, released the following statement:

The significant new cuts in oil production announced by OPEC+ countries come during a period of heightened uncertainty for global oil markets and concerns about the outlook for the world economy. Forecasts by the IEA and other relevant institutions, representing consumers and producers alike, all indicate that global oil markets were already set to tighten in the second half of 2023, with the potential for a substantial supply deficit to emerge. The new OPEC+ cuts risk exacerbating those strains and pushing up oil prices at a time when strong inflationary pressures are hurting vulnerable consumers around the world, especially in emerging and developing economies.

Clearly the market expects the imbalance to flow through to price at some stage, but trying to time this is a difficult task. One factor alone – the duration of the Russian war – could impact this timeline by months, if not years. Trying, therefore, to pinpoint the price of Crude come 6 months from now seems like a futile exercise.

Near vs longer term prospects

Given our reliance on OPEC oil in the near term (and by near, I mean the next decade) the price of oil will likely gravitate towards whatever Saudi Arabia – as OPEC’s producer-in-chief – needs it to be. Oil is by far the largest contributor to the Kingdom’s fiscus. In the last few years, it accounted for about 40% of real GDP, but around 75% of their total budget. This number got as high as 93% in 2011 and as low as 53% during the Covid pandemic. Today, Saudi is clearly trying to shift their economy to be less oil reliant, with ongoing efforts to position themselves as a global travel and events hub. This transformation does not come cheap though, and Saudi will be reliant on oil for years to come.

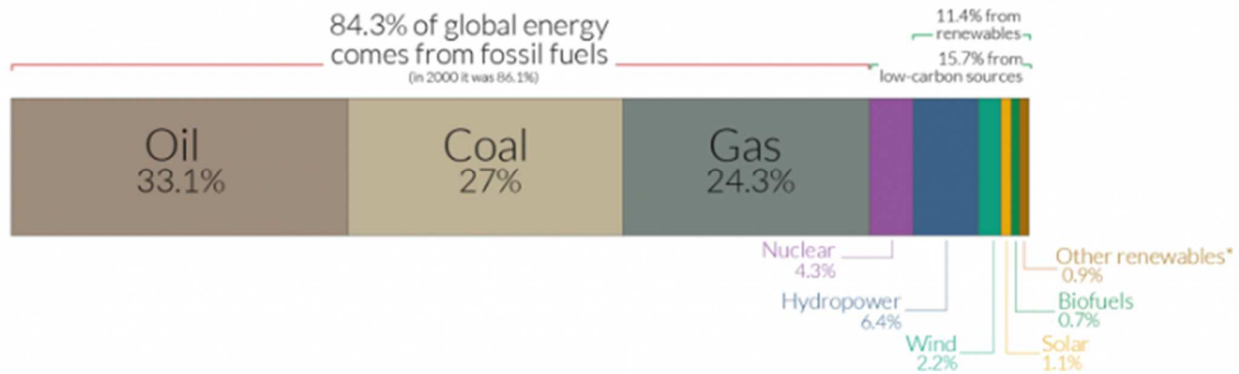
Consensus is that they need the price of Brent crude to be more than \$80/barrel in order to cover the government’s spending bill, but this number is hard to verify. And while further cutting production would assist in achieving the required price, it has to be balanced with maximizing revenue, i.e. maximizing volume.

Luckily for Saudi Arabia, despite the massive investment into renewable energy sources over the last decade, we are far from quenching the global economy’s thirst for fossil fuels. In fact, demand is proving to be much stickier than what many would have expected.

In 2019, fossil fuels accounted for 84.3% of global energy consumption. Two decades ago, in 2000, it was 86.1%. That means a drop in market share of only 1.8% over 20 years, despite all the investment into lower carbon sources in the meantime.

Global primary energy consumption by source

The breakdown of primary energy is shown based on the 'substitution' method which takes account of inefficiencies in energy production from fossil fuels. This is based on global energy for 2019.



Other renewables includes geothermal, biomass, wave and tidal. It does not include traditional biomass which can be a key energy source in lower income settings.
OurWorldinData.org - Research and data to make progress against the world's largest problems.
Source: Our World in Data based on BP Statistical Review of World Energy (2020).

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The longer-term (decade+) equation is even murkier and will, to a large extent, depend on how successful countries are in achieving their long-term sustainability goals, as well as whether there is sufficient oil production to meet demand.

While there is no shortage of commitments from major governments and corporates around the world, executing on all of these is another story. The International Energy Agency (IEA) has identified three different scenarios for future energy usage, based on how effectively these commitments are met:

- **STEPS:** Stated Policies Scenario (*reflects current policy settings*)
- **APS:** Announced Pledges Scenario (*assumes all climate commitments made by governments around the world, and longer-term net zero targets, will be met in full and on time*)
- **NZE:** Net Zero Emissions 2050 Scenario (*assumes the global energy sector achieves net zero emissions by 2050, without relying on emissions reduction from outside the energy sector to complete its goals*)

Their base scenario considers current industry plans, government policies, as well as existing energy transition initiatives. Based on this scenario, global oil demand is still forecast to rise by 3.5 million barrels per day by 2025 – a far cry from the decline of 3 million barrels/day required to meet World Energy Outlook's Sustainable Development Scenario, which follows a trajectory consistent with the climate goals of the Paris Agreement. The pathway to the NZE scenario would require a much sharper decline in oil consumption – a prospect that currently looks unlikely.

Aside from this, there has also not been enough investment into minerals and materials to support the planned energy transition. Over the last few years, reports from the IMF, IEA and World Bank have pointed this out. Minerals like copper, for example, have seen their prices skyrocket. These minerals will play a crucial role in any energy transition – as they are used in a number of reduced-emission products, like solar panels, wind turbines and lithium batteries.

While there is little doubt that renewables like wind and solar will increase its share of the energy budget in the coming years, it is also clear that oil's own day in the sun is not yet done.

Underinvestment in supply

For the last decade, the fossil fuel industry has also seen underinvestment in supply, as Western oil conglomerates face increased pressure from activist shareholders to clamp down on any new non-renewables capex. This has not had a major effect on the profits of the big oil conglomerates which have actually benefitted from capex spend being slashed. It has, however, had a clear effect on downstream oil services companies, like Schlumberger, Halliburton and Baker Hughes, whose profits have collapsed as they are tied to oil exploration.

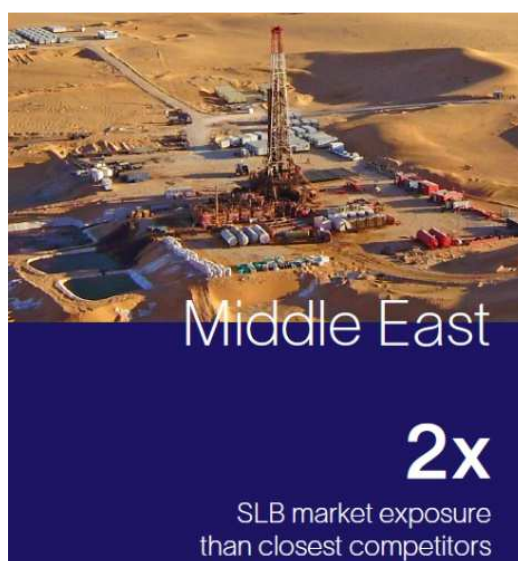
Underinvestment in supply will eventually self-correct as markets respond to higher-for-longer oil prices, even if this investment is not made by Western oil conglomerates. National oil companies, not beholden to activist shareholders, have already started to increase their exploratory capex based on their favourable long-term projections for oil prices, and oil service companies stand to benefit disproportionately as demand for their services ramp up.

An example of this would be Schlumberger (now renamed SLB). If there is one region that would want oil to remain the world's go-to energy commodity, it would be the Middle East. SLB has a large overweight exposure to this market - more than double that of their closest peer. This bodes well for them, given their CEO's statement last year that the current investment cycle in the region is the largest in history, supporting the view that National oil companies, like Saudi Aramco, will be much more willing to spend on Capex compared to publicly listed conglomerates.

SLB finds itself in a crucial industry with a poor ESG reputation, while they manage to deliver peer-leading scores. This is a factor that will likely become more important as the energy transition develops, and puts SLB in a good position to continue offering their services. Aside from traditional fossil fuel services, SLB has also pivoted into providing services for more sustainable forms of energy generation, basically covering both ends of the spectrum.

This puts them at the forefront of the industry with innovative solutions to help address the climate crisis, weaving decarbonization and digital solutions into a future growth driver, while still capitalizing on their core area of expertise in traditional oil field services.

In summary, while in the short-term oil prices are largely a function of OPEC's decision to "open or close the taps", in the long term, market fundamentals will come to the fore. These are likely to be favourable as a result of sticky demand and a decade-long underinvestment in oil exploration which is only now beginning to correct itself. Oil services companies stand to benefit disproportionately from this trend.



Glacier Research thanks JD Hayward for his contribution to this week's *Funds on Friday*



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