

## **OIL MARKET FORECAST – JULY 2020**

### **Summary**

The oil demand picture in July 2020 is similar to June, indicating that the market is settling down after a turbulent few months. June saw the first draws on global oil storage in 2020, as demand exceeds supply, with a supply deficit expected for the balance of the year as a result of ongoing OPEC+ supply curbs and voluntary production shut ins. Other items to note:

- OPEC+ reaffirmed their commitment to maintain supply curbs at their meeting of the 15<sup>th</sup> of July.
- Despite favorable news last week, Libyan production is still unable to reach the market.
- OECD Oil inventories will fall to their long-term average at around the end of the year.
- Average US land oil rig counts fall to 275 in 2020, average US oil production falls to 15.9 MMbbl/day in 2020.
- Oil prices have recovered to a level that may see an uptick in US shale well completion activities but are not yet high enough to support a rebound in drilling activity.
- Under current assumptions, the oil market is broadly in balance in 2021 and 2022 as oil demand recovers.
- A structural supply deficit emerges in 2023 and continues beyond as demand recovers while supply stagnates.

This forecast sees a strong rebound in 2023 and beyond as surplus inventory is worked off and supply falls short of demand. The timing of the rebound is sensitive to number of factors, such as OPEC+ compliance, global response to COVID-19 and the resolution of involuntary production curbs as in the case of Libya. While the timing is uncertain, the direction of travel is clear. US onshore production growth would be unable to keep pace with rising demand, triggering the start of the industry's next investment cycle.

### **Oil Supply and Demand**

The demand estimates from the latest IEA report<sup>i</sup> is consistent with June, they estimate demand at 91.9 MMbbl/day and 97.4 MMbbl/day for 2020 and 2021 respectively. The latest EIA report<sup>ii</sup> is more bullish over the June edition, with demand at 92.9 MMbbl/day for 2020 and 99.9 MMbbl/day for 2021 respectively. The key difference between the two estimates concerns the return of air travel in 2021. The IEA do not see a return to 2019 air travel levels until 2022, whereas the EIA are more optimistic, seeing demand recovering more quickly.

Given the current resurgence in COVID-19 cases and the increased imposition of travel restrictions, the EIA assumption appears optimistic, so this forecast has adopted the IEA demand estimate for the next two years. Revised data for May indicates that demand was substantially stronger than previously estimated and this update has been incorporated in the forecast.

While demand has been stronger than expected, new data for April and May shows that supply cuts were steeper. Global production was 1.8 MMbbl/day and 1.7 MMbbl/day lower for April and

May respectively when compared to previous estimates. Around half of the May production differential can be attributed to lower than estimated production from the US, as producing fields were shut in.

In terms of production forecasting for the remainder of the year, OPEC+ re-affirmed its commitment to maintain its agreed program of production cuts through 2021, following their Joint Ministerial Monitoring Committee Meeting of the 15<sup>th</sup> July, despite improving market conditions. The agreement removed a major source of supply uncertainty, at least for this month, as the market is entirely dependent on that agreement to work of its surplus and achieve balance by the end of the year. The press release also announced an agreement that nations which had produced in excess of agreed levels over the prior months would make good on those commitments by undertaking additional cuts through September, further suppressing supply.

The gradual rise in oil prices over the last couple of months has prompted US operators who had voluntarily shut in production to bring those wells back online. This coupled with the end of additional voluntary reductions by Saudi Arabia, Kuwait and the UAE, should see production start to rise in July, followed by a further rise in August as OPEC+ moves to phase II of its supply agreement.

Prices have yet to recover to a point that will spur investment in new production, leaving the biggest near-term production uncertainty is Libya. Libya has sustainable production capacity of 1.2 MMbbl/day but has been producing 10% of that as an ongoing civil war prevents export. Late last week Libya's National Oil Corporation announced that exports could re-start, only to reverse the announcement on Monday 13<sup>th</sup> July. Near term supply and demand is finely balanced and the impact of additional production from Libya is material. The forecast has been updated to assume Libyan production returns gradually through 2020, reaching sustainable production capacity in 2021.

## Oil Market Balance and Storage

OECD oil inventories began to draw down in June by an estimated 157 MMbbl. Draws are forecast to continue at this level through the rest of 2020, as the OPEC+ supply curbs restrict supply and demand recovers. The latest forecast shows small excess supply in 2021, due to the revised assumptions about Libyan production, before demand outstrips supply again in 2022 and beyond, as demand recovers. A supply and demand and surplus forecast is shown in Figure 1, below.

The key uncertainties in this forecast are the impact of COVID-19, adherence by OPEC+ members to production cuts, the underlying decline rate of US shale production and the return of Libyan production.

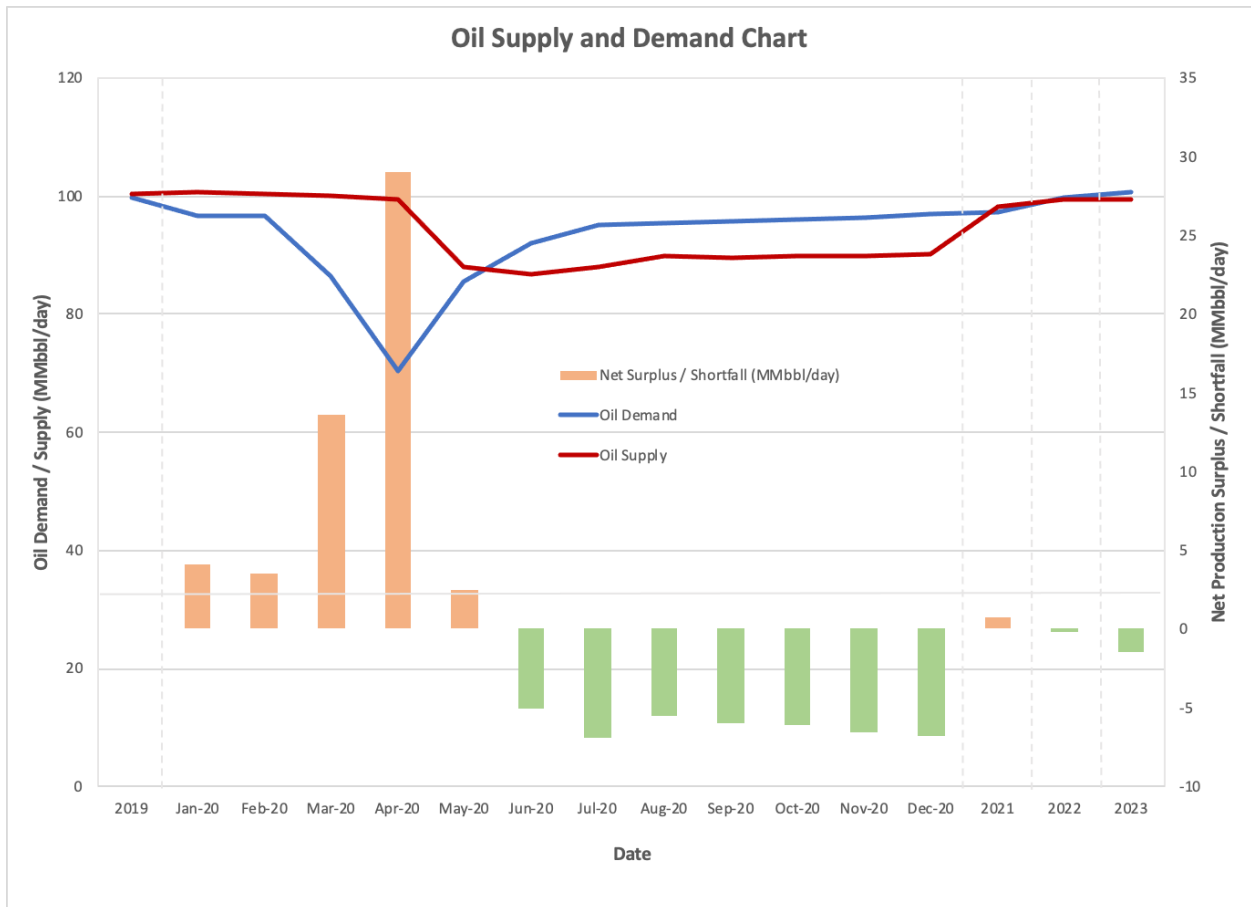


Figure 1 - Supply and Demand and Surplus Forecast

The June oil supply shortfall is estimated at 5.1 MMbbl/day, with an estimated July oil deficit of 6.9 MMbbl/day. The OPEC+ production cuts, together with better than expected demand have slowed the build in crude inventories. Whereas in April there was widespread concern about exhausting physical storage, this scenario now seems very unlikely as stored crude is worked off.

The overall impact of higher demand and lower supply is that OECD crude storage should fall back to its 5-year average around the end of 2020. Crude in storage is now predicted to build again

in 2021 as the OPEC+ supply curbs are lifted and Libyan production returns to market, but demand is predicted to outstrip supply in 2022 and 2023. This is shown in Figure 2, below.

The emergence of a structural supply deficit is driven by the decline in US shale production caused by the fall in investment in the play. The underlying decline rates of US shale wells are much steeper than conventional wells and so production falls quickly unless investment is maintained. As US shale has been the major source of production growth over recent years, lack of investment in the coming years, couple with natural declines, creates a structural supply deficit.

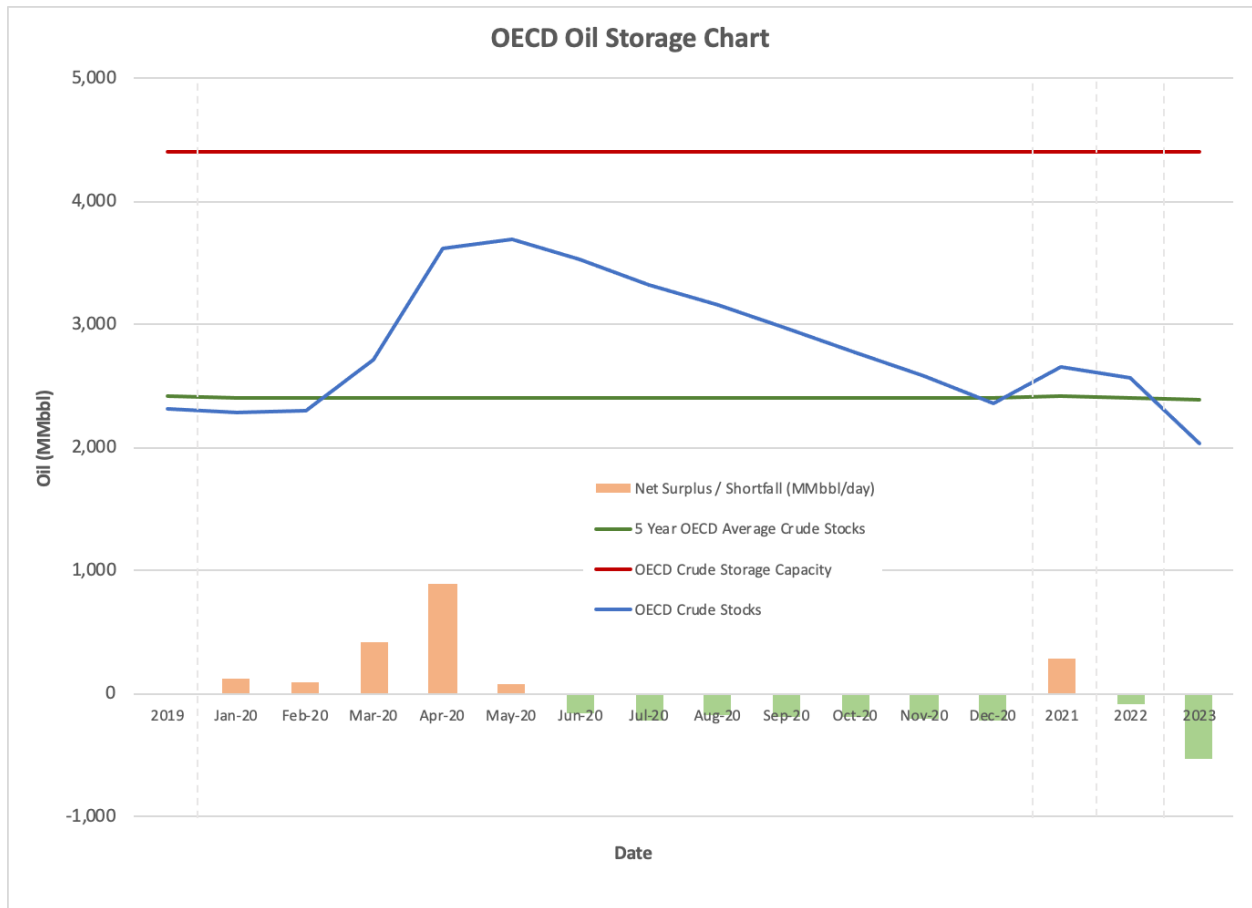


Figure 2 - OECD Oil Storage Chart

### Impact on US Investment and Oil Production

As noted earlier, the recovery in prices has resulted in several US operators choosing to bring shut in production back online. For many of these companies, however, the economics of operation are worse today than they were in the second quarter, as production hedges have rolled off, realized prices have fallen even as spot market prices have risen.

The second quarter of the year saw hydraulic fracturing crews demobilized at a faster pace than drilling rigs, which is probably due to differences in contract structure between the two services. Given this it is reasonable to expect that the inventory of drilled but uncompleted wells has grown over the second quarter of the year. West Texas Intermediate spot prices have crossed the \$40 per

barrel threshold and production can be hedged at prices in the low forties for the next couple of years. This is an environment where it begins to make sense for operators with good acreage, low operating costs and capital to start working through their backlog of drilled uncompleted wells. As a result, there may be an uptick in completions activity over the second half of the year.

The situation for new wells is different, with no indication on the horizon of price support for new US onshore oil wells in the near term. This forecast sees average annual US oil rig counts falling to 275 in 2020, and 200 in 2021 before recovering. The 2020 rig count estimate is in line with last month's forecast.

The US land oil rig count has continued to fall steadily over the last month with 169 rigs in operation as of the 10<sup>th</sup> of July. This decline is set to continue with 70 land oil rigs estimated to be in operation by year end, as shown in Figure 3. If gas rig counts remain flat for the remainder of the year, the total land rig count at year end would be about 145. A moderate rebound in rig activity is forecast for 2021, with an average US land oil rig count of 200 for the year, which implies 330 US land oil rigs active at the end of 2021.

US annual oil production is forecast to fall from a record 17.2 MMbbl/day in 2019 to 15.9 MMbbl/day in 2020 bottoming out at 14.6 MMbbl/day in 2021 before returning to growth. US oil production is shown in Figure 4, below.

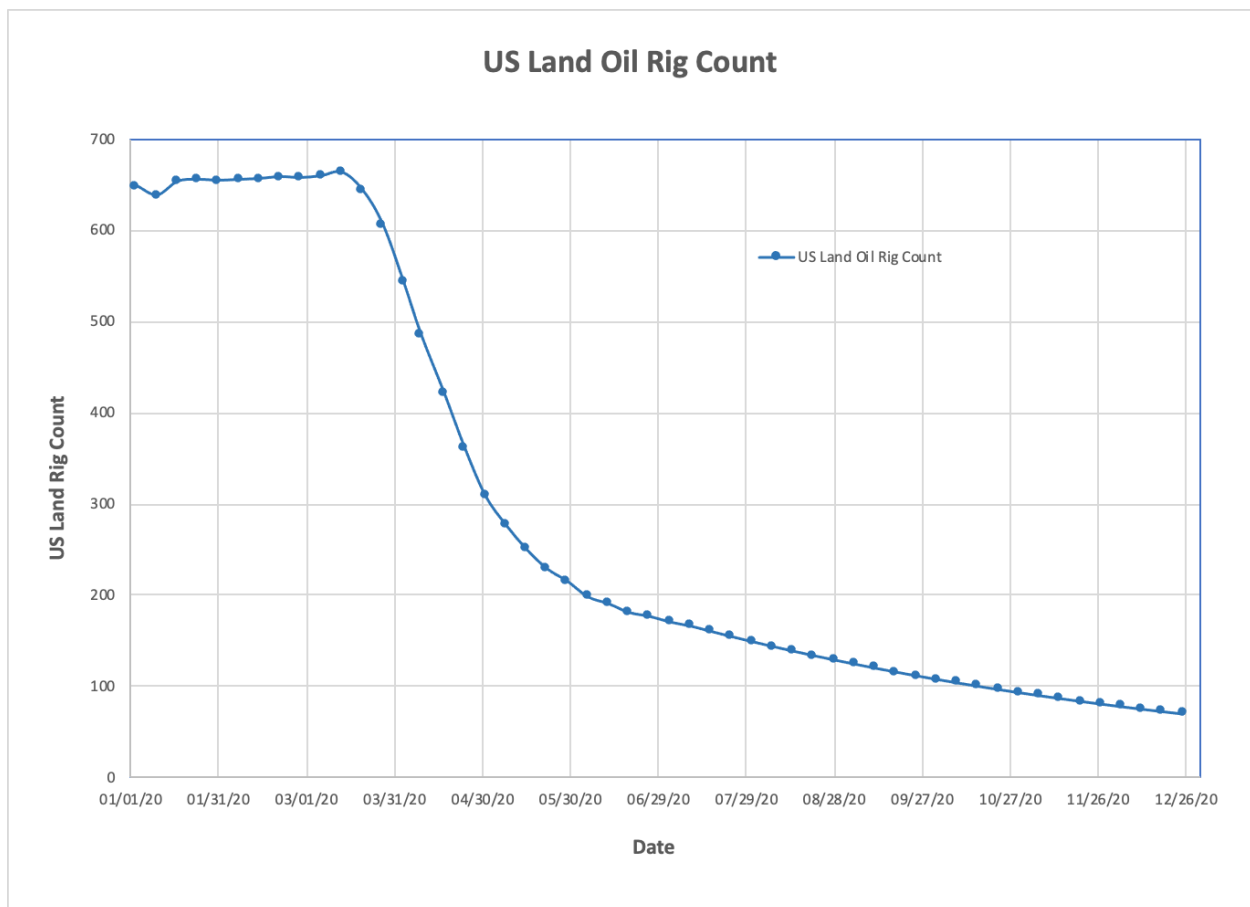


Figure 3 - US Land Oil Rig Count

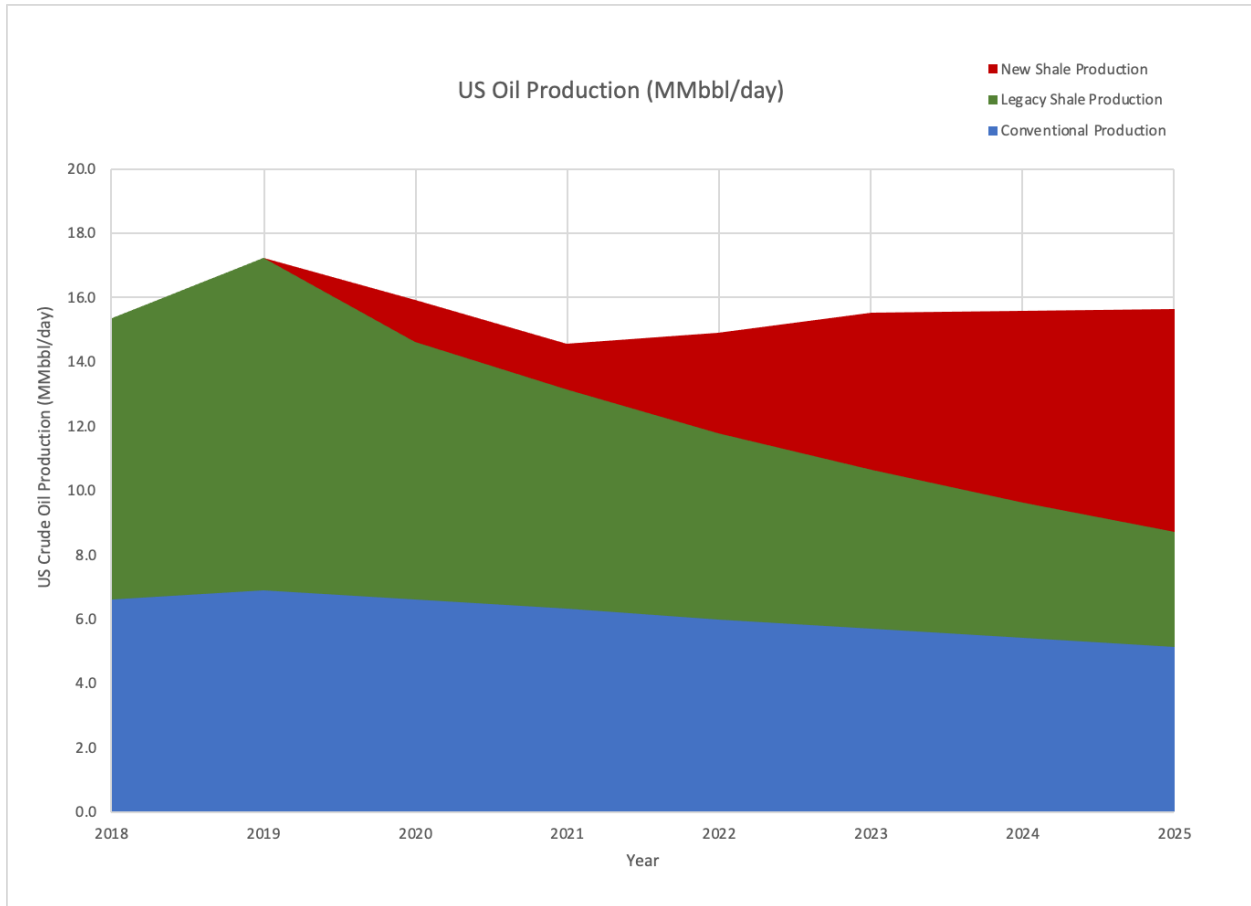


Figure 4 - US Oil Production Forecast

<sup>i</sup> IEA (2020), Oil Market Report - July 2020, IEA, Paris <https://www.iea.org/reports/oil-market-report-july-2020>

<sup>ii</sup> Short Term Energy Outlook (STEO), July 2020, U.S. Energy Information Administration.