Launch of *Medium-Term Oil Market Report 2015*
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London
10 February 2015

Ladies and gentlemen,

Over the past months I have been asked consistently and constantly: when does the IEA expect oil prices to rise? How high will they rise? What happens next?

In response, I have preferred not to focus on forecasting, but rather on how to best use the opportunity of low oil prices to our advantage – whether that be by reducing fossil-fuel subsidies, imposing a price on carbon, or stimulating investment in renewable energy.

But today will be a bit different. In fact, everything about today’s oil market is a bit different. While there have been drops and price corrections roughly every ten years since the price shocks of the 1970s, there has never been a situation like what we are facing today.

Of course there will be a rebalancing of the market. But the rebalancing may not be what we have grown to expect. This time around it is not business as usual.
Most significantly, US light, tight oil – or LTO – has unlocked a vast resource that long seemed off-limits. This has profoundly upended the traditional division of labour between OPEC and non-OPEC countries.

This shift in underlying market conditions will result in a different form of readjustment to the price drops than what we have seen the past. Usual logic suggests that the faster the rally in price, the more severe the inevitable correction. This much has proven true once again – after years of sustained record prices, the decline was indeed severe.

However the same logic suggests that the deeper and faster the price decline, the stronger the recovery. Signs point to this rebound being different – the advent of LTO has made non-OPEC supply far more price elastic than in the past. On the other hand, demand has become significantly less price elastic. That suggests that the market response to this selloff will be swifter, but also perhaps less violent, than those to earlier price declines of a similar magnitude.

This unusual supply response to lower prices is just one more example of how LTO has changed the energy landscape. OPEC’s move at its November 2014 meeting to let the market rebalance itself is a reflection of that fact. This is not the first such move by OPEC, but we must look back to 1986 to find another – and single – example of OPEC deliberately refraining from managing supply.

But of course shale oil was not around in 1986. So today, OPEC’s move may have effectively turned LTO into the new swing producer. But it will not drive it out of the market. LTO might in fact come out stronger.

This is our medium term forecast in a nutshell. Because let us be honest, the oil market of 2015 is not the oil market of 1986 or indeed of 2008. US light tight oil has changed the rules of the game.
It comes as no surprise that global capacity growth will slow over the coming years.

This year’s Medium Term Oil Market Report tells us that US LTO growth will slow significantly in the early part of the forecast in response to low prices. This drop will not be the only form of supply response, but it will be a large piece of it. And cuts in LTO investment will be faster to translate into actual supply cuts than those in other projects with longer lead times. Much for the same reason, LTO production growth will also be faster to come back on the rebound.

All in all, LTO is expected to remain a top source of incremental supply, with growth initially slowing but swiftly regaining momentum later on. Questions do remain about the availability of capital to LTO producers, but relatively speaking any investment cutbacks are not expected to have a long-lasting impact.

You will notice that most of the growth on this slide is from non-OPEC. Despite OPEC’s stated policy of defending market share, it is only expected to contribute roughly one third of global capacity growth. OPEC is expected to halt, but not reverse, the slide in its share of global liquids capacity.

It will succeed, however, in regaining a larger market share in terms of global supply, but only up to a point. Assuming it continues to produce at current levels early in the forecast period, then raises production as soon as the “Call on OPEC” exceeds its current output, OPEC’s share of global production will indeed grow. But it will not revisit the higher levels reached before the financial crisis of 2008-2009.
This of course also assumes everything goes right with OPEC production. Because forecast OPEC capacity growth is also exceptionally lopsided, and highly risked. Indeed nearly 90% of OPEC capacity growth will come from a single country – Iraq. This is not the quietest neighborhood nor the easiest place to operate. But Iraq has already done wonders under extremely adverse conditions, and it has the capacity to do more.

The list of challenges facing Iraq grew longer last year with the campaign waged by the Islamic State of Iraq and the Levant and the price collapse. But this has yet to derail its medium-term production outlook. As recently as December, Iraq’s production surged to a monthly average of 3.7 million barrels per day, a 35-year high.

Iraq is a good example of how the effects of low prices can be double-edged. On the one hand, the price drop makes production both more difficult to finance and less profitable. On the other hand, it is an incentive to hike production volumes to make up for the loss of revenue, and to resolve in a hurry all the problems that had been holding down production.

What this also means, however, is that the overwhelming majority of OPEC production growth is at significant risk, depending on political instability.

Outside of Iraq, the outlook for other OPEC countries is looking dimmer. Venezuela and Nigeria will both feel the impact of low prices, leading to tighter budgets and cuts in social spending. Gulf countries may also miss their economic targets, though they have the advantage of higher buffers. Countries like Angola and Ecuador face serious difficulty.

There is a possibility that Iran could rapidly increase production and exports if agreements were reached over its nuclear program, but this is far from assured and this is not the case assumed in our report.
Outside of OPEC, Russia will be hit particularly hard.

As I noted earlier, US LTO is price elastic. If it’s not selling, production can theoretically be slowed and halted in a matter of weeks. In practice things may be a bit more complicated, depending on how producers are hedged and other factors, but at the end of the day this is all about economics, and the economics of LTO makes it sensitive to changing prices.

Russia is the polar opposite – its conventional production faces a perfect storm of collapsing prices, international sanctions, and currency depreciation. Russia will likely emerge as the industry’s top loser with production set to contract by 560 thousand barrels per day over the period 2014 to 2020. Unfortunately the knock on effects from Russia’s struggles could be significant for a number of countries in the region.

Other regions will see slower production growth or steeper declines as a result of the lower prices. Big ticket projects will be pushed back, notably in deep-water West Africa and costly EOR projects elsewhere. Maintenance will be cut back as producers will seek to squeeze as much as possible from producing fields, resulting in steeper decline rates later on.

At the end of the day, North America’s unconventional production will loom even larger in total supply than before the price drop.
This is not business as usual in demand either. Low prices are normally seen as a boon to the economy and to oil demand growth. But it might not work out quite that way this time around.

First and foremost, the world economy remains relatively weak, and in fact projections of oil-demand growth have been revised downwards, rather than upwards, since the price drop. Weak demand, due to the lingering effects of the Great Recession, is part of the reason why prices fell in the first place. That makes it less likely that lower prices will in and of themselves fuel a large increase in demand.

There are undoubtedly economic benefits to be expected from lower prices, including higher household disposable income – a sort of tax cut – and lower industry production costs. But those may be partly offset by the deflationary environment of some of the largest OECD economies. Outside of the OECD, weakening currencies mean that lower prices in US dollars will not necessarily seem that much lower to end users in domestic currencies. That will be compounded by the fact that many governments are rightfully seizing the opportunity of lower prices to dismantle their costly and ineffective subsidy programs.

And then there is the fact that the global economy has become less oil intensive and that oil is facing more competition from other fuels.

This is not all to say that demand growth will not gain momentum as the global economy slow improves. But it will do so more slowly than had been expected, in line with the IMF forecast of underlying economic growth.

And with upstream investment being cut back, demand is forecast to run ahead of supply gains by as much as 1 million barrels per day over the next six years. This will result in significantly tighter balances by 2020.
Stepping back to take a global picture, what we see is a shrinking and fragmenting market.

With LTO price elasticity keeping the United States firmly in its role as major provider of oil-supply growth, North America will continue to source more of its crude locally. This will have the effect of backing out seaborne imports, even as China and the Middle East continue to ramp up refinery throughputs. The Middle East will export less of its crude and will keep more to refine at home, both to meet domestic demand and to export as products.

The result of these changes will be a continued shift of the global oil market from crude to products, with contraction and fragmentation in crude markets mirrored by expansion and globalization in product markets.

The relative majority of demand remains in Asia and non-OECD economies, and it is the Middle East that gains a larger share of the traded market. By 2020 the Middle East and Asia will be locked in an even tighter energy embrace than today.
For refiners, the product market is expanding, and that’s both good news and bad news. Good news, as the industry will increasingly achieve economies of scale, become more efficient, and extend its marketing reach as the product market globalizes.

But bad news for the more vulnerable components of the industry, notably some of the smaller and more antiquated refineries of Europe, and in Asian OECD members, which will suffer from both diminishing demand at home and growing competition overseas.

Indeed, the hollowing out of the European refining industry amid growing competition from North America, India, China, Russia, and the Middle East will leave Europe increasingly import dependent for its middle-distillate needs. Asia buyers, on the other hand, will enjoy unprecedented buying power as crude exporters will be forced to compete more aggressively in the same Asian markets, as both North America and Europe, albeit for very different reasons, require less imports of seaborne crude.

Although growth in refining capacity will, on paper, track growth in end-user demand, in practice the refining industry will be piling up excess capacity in the next few years. That’s because up to one third of incremental product demand is expected to be met by liquids that will bypass the refining system altogether, such as biofuels, coal to liquids, or gas to liquids. As such, refinery margins are expected to remain under pressure, despite a significant improvement since the second half of 2014, when a large portion of surplus capacity was shut.
We should also take a moment to remind ourselves that the market is not simply about price, supply, and demand. For example, in 2020, a change in fuel oil specifications by the International Maritime Organisation for bunker fuels – 4% of the total market –is set to have significant impacts. This is a perfect example of how policy measures can undermine oil-demand growth even in the face of falling prices.

Shippers that for many years supported demand for high-sulphur residual fuel oil will now be forced to look for alternatives – some will choose lower-sulphur marine gasoil. Others may choose to continue to run on residual fuel bunkers, and instead install scrubbers, and some may choose to switch to liquid natural gas. So far, we have not seen the shipping industry making investments on a large scale.

But if it came to pass that the majority of high-sulphur bunkers were replaced with marine gasoil, significant new investments would be needed for the refining industry, on top of those already announced.
Ladies and gentlemen,

It is a different world than it was last time we saw an oil price plunge. Emerging economies, notably China, have entered less oil-intensive stages of development and indeed the global economy in general has become less oil intensive. On top of this, concerns about climate change are influencing energy policies, renewables are increasingly pervasive, and a globalized natural gas market is rewriting the rules of inter-fuel competition.

In these ways and many others, it is a different world than it was in the ’90s, ’80s, or any time before. So while there will be winners and losers as the market rebalances itself over the coming months and years, one thing is certain: the oil markets will never again be the same.

Governments, businesses, and decision makers must make no assumptions based on what they have seen in the past. It is time to look ahead.