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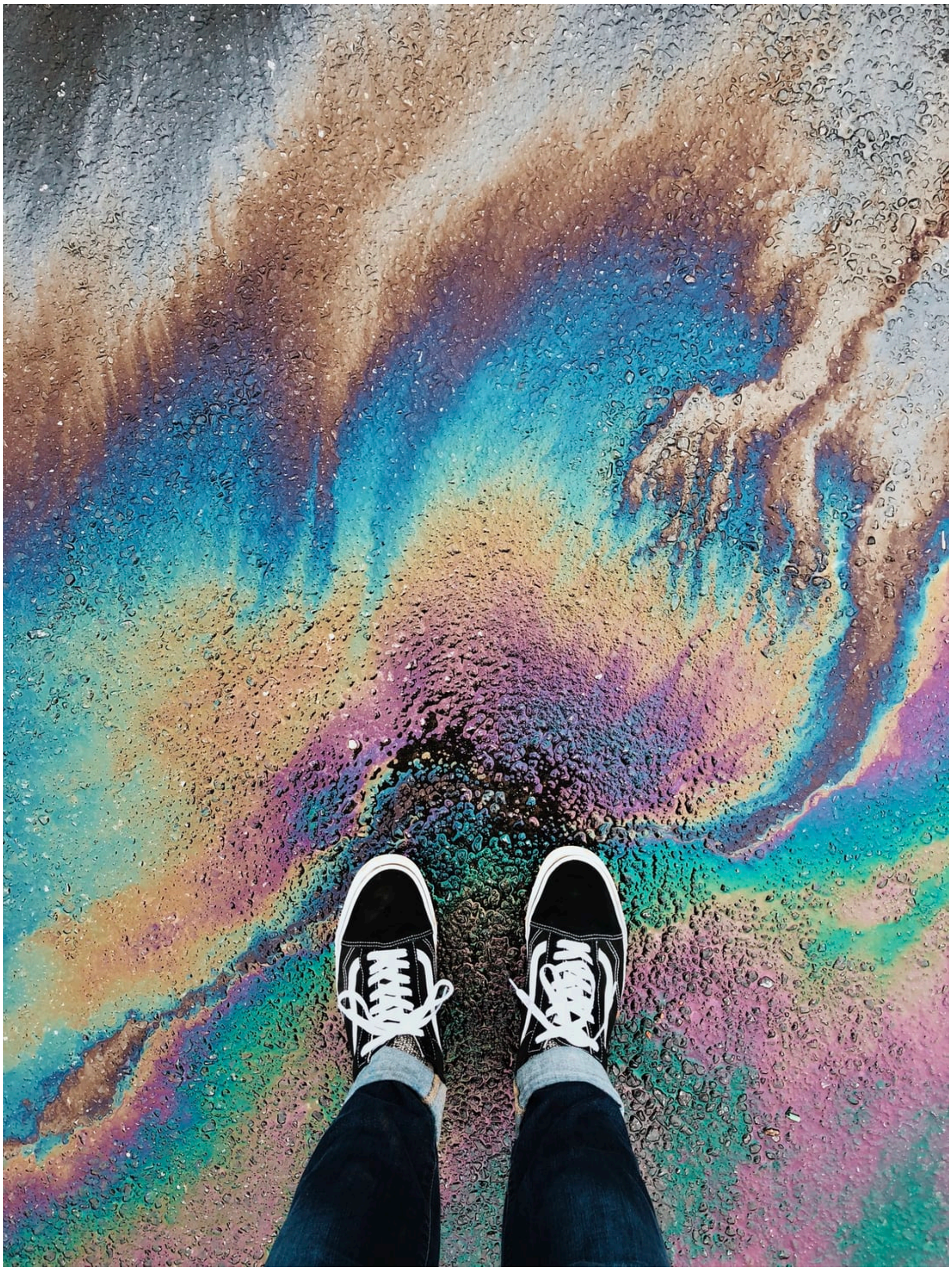
What lies beneath the subzero oil price?



On
Monday, the price of West Texas Intermediate (WTI) crude (for next day delivery) dropped into negative territory for the first time in history. How could it be possible that one of the most used physical commodities in the world was momentarily worth less than nothing? It is true that we are in an oil glut, with coronavirus wiping out demand, pushing storage terminals towards full capacity - despite the recent decision by the quarrelsome OPEC+ cartel to cut production by 10 million barrels per day. However, the extreme drop into negative territory was mostly due to technical factors in the US futures market. For this reason, the same extreme price decline did not play out for Brent crude. On the same day, WTI crude oil futures plunged 305% to a negative -$37.6 per barrel while Brent crude fell 8.9% to $25.6 per barrel.

The major difference between the two types of crude is that Brent Crude originates from oil fields in the North Sea between the Shetland Islands and Norway. Oil extracted in Europe, Africa, and the Middle East is typically priced relative to this benchmark. Brent crude is seaborne and can be delivered to a variety of locations and is currently less affected by storage space scarcity. WTI is sourced from U.S. oil fields, primarily in Texas, Louisiana, and North Dakota.

Historically, Brent Crude and WTI traded closely, but recently their prices have started diverging. This divergence can be explained by many different factors including storage availability, refining capacity or even political risk.

Monday's gaping discrepancy between Brent Crude and WTI prices can largely explained by capacity shortages in the US which is awash with oil. WTI May-dated futures contracts had an expiry date of 21st April meaning holders of the contracts on this date had to take delivery of the oil. The holder of a WTI futures contract has to take delivery at Cushing, Oklahoma. The highest quantity of oil ever stored at Cushing was 69.420 million barrels. On April 9th it held 54.965 million barrels and is estimated that it is now holding above 60 million barrels. As a result, there was no storage space available for the May contracts to be delivered. Traders therefore had to ditch their contracts (or pay someone to take it off their hands).

Through
Monday's precipitous drop was caused by the mechanisms behind the futures

market, the ultra-low oil price, outside of this momentary issue, shows an industry under immense stress. Taking a look at the actual supply-demand situation for oil, it is unlikely that by the time the next contracts expire, the storage situation at Cushing will be very different from how it is now. Even before the US driving season (which kicks off on Memorial Day and runs through September), US gasoline demand was down by more than 30% this month, compared to a year ago according to the Energy Information Administration (EIA). This means supply is piling up and now, oil is now being stored on previously empty tankers because land-based storage facilities are overflowing.

The prices of these futures will need to connect to the physical reality, and they are likely to crack lower. With prices in prohibitive territory, producers will be forced to shut-in production, if they aren’t already doing so. This could result in mass layoffs and if oil producers become insolvent, the ripple effects will be felt throughout the economy, mainly for bondholders and banks with exposure to oil producers.

At a more global level, the rout in the oil price complicates the task facing central banks to keep economies afloat as the pandemic continues to paralyze business and travel worldwide.

Oil ministers from the OPEC+ coalition held an unscheduled conference call on Tuesday to discuss the collapse without settling on new policy measures. The Texas Railroad Commission, meanwhile, opted to put off a decision on whether to impose oil-production quotas.

Absent a robust policy response and further production cuts, the price of WTI will likely remain under pressure, as the storage situation at Cushing is unlikely to ease and global demand will not recover for the next few months at the very least.

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