Oil

Why the price of oil has dropped despite new constraints on Russian supply

Crude settles at lowest level of 2022 after European embargo and G7 price cap take effect

An oil tanker in the Bosphorus Strait, where vessels queued this week © Reuters

Derek Brower in New York and **David Sheppard** in London 9 HOURS AGO

This week marked a pivotal moment in global geopolitics, as a European embargo and G7 price cap on Russian crude came into force.

Russia, faced with the humiliation of western powers dictating the price it earns for its oil, threatened to halt exports to any countries complying with the price cap. Within hours, supply disruptions were visible as a backlog of tankers queued in the Bosphorus Strait.

All of this would ordinarily have sent oil prices sharply higher, especially just weeks after the Opec+ cartel surprised the market by announcing deep new supply cuts. Yet on Thursday, the international oil benchmark Brent settled at $76.15 a barrel, a new low for 2022. What is going on?

Russian supply remains robust

Europe's ban on crude oil imports from Russia, the world's biggest oil exporter, is a genuine sanction, aiming to force Moscow to reroute supplies and halt the ugly optics of allies of war-torn Ukraine funnelling petrodollars to President Vladimir Putin.

But the G7's price cap plan aims to take the edge off.

When the EU announced it would impose sanctions on any tanker hauling Russian

When the EU announced it would impose sanctions on any tanker hauling Russian crude, even one sailing to Asia, there was concern in some western capitals that the measures would bring a crash in Russian exports and a rise in oil prices. Western politicians would suffer the blowback from more inflation. Putin might rake in more oil money.

The price ceiling, however, intends to keep Russian oil headed to customers and oil costs from shooting higher. Other measures tied to the price cap have also been scaled back, giving traders some reassurance that flows will continue largely unabated.

The US persuaded the EU to drop one clause in its sanctions, for example, that would have banned vessels from receiving European maritime services forever if they broke the price cap. The punishment has been scaled back to a 90-day ban.

The cap, set at $60 a barrel, was designed “to make sure that a sharp increase of price is not used to divide the alliance and weaken the ability to support Ukraine [and] to make sure there’s not an ability to surge the income of the aggressor to pay for continuing the aggression”, said Amos Hochstein, US president Joe Biden’s senior energy adviser.

Russia has refused to deal with any buyer that wishes to utilise the cap, but western officials say the $60 level is still helping Asian refiners negotiate lower prices

“Russian supply to the market remains as high as at any point all year,” said Florian Thaler, head of OilX, which tracks global oil movements. Any drop would only be visible later in the first quarter of 2023, he added.

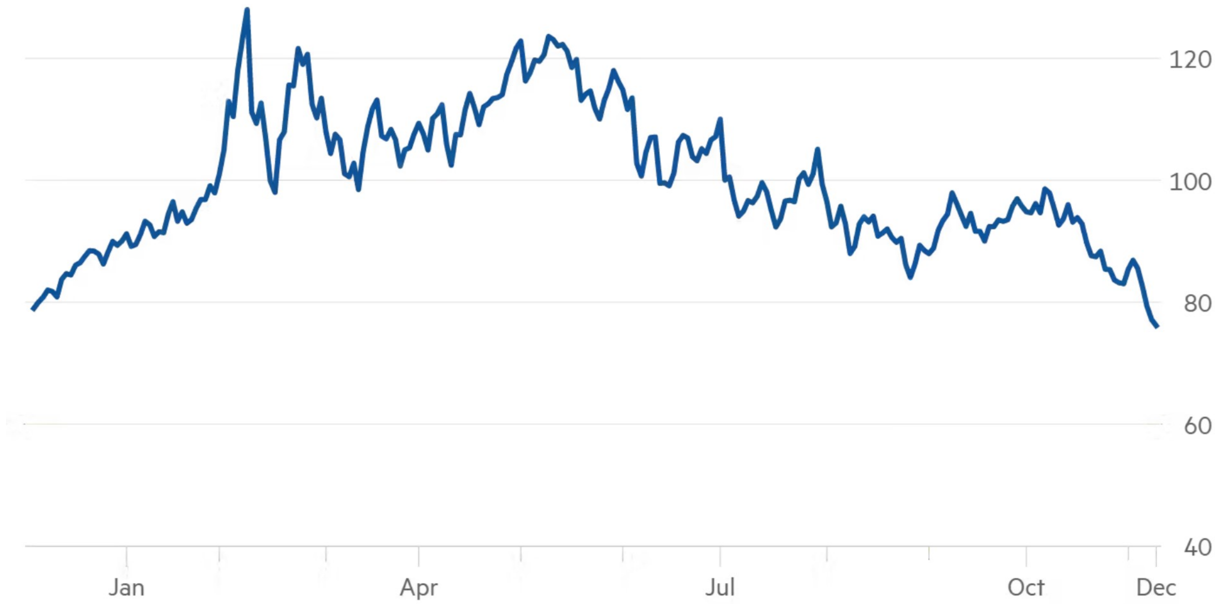
The deep Opec+ cuts are not that deep

In October, when Saudi Arabia, Russia and other Opec+ allies announced a cut of 2mn barrels a day to production quotas — equivalent on paper to about 2 per cent of global supply — the reaction from the west was swift. Riyadh was siding with Russia in a global energy war, the White House suggested. The International Energy Agency accused the group of endangering the world economy.

But while energy-led inflation is still a problem in western economies, the past five weeks suggest the move by the Opec+ group was relatively shrewd.

Oil drops to lowest level of 2022

Brent crude, $ per barrel



Source: Eikon
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Oil prices have not soared but slipped, adding fuel to an argument made by Saudi energy minister Prince Abdulaziz bin Salman that in the face of a weakening global economy, pre-emptive cuts were needed to halt a sharp market drop. Opec+ maintained production targets when it met last Sunday.

The actual cuts made by Opec+ have also been smaller than the headline number announced in Vienna, partly because some producers such as Angola and Nigeria were already struggling to hit their quotas. Instead of 2mn b/d removed from the market the total is closer to 1mn b/d, say analysts — still substantial, but not enough to flush out the oil bears.

Demand fears are trumping supply concerns

After months of fretting over supply disruptions, traders are now focused on fears of global recession, as the fallout from Russia's invasion of Ukraine and energy war on the EU spreads and central banks race to ratchet up interest rates to tame runaway inflation.

Wall Street banks have issued wary economic outlooks for 2023. "When I talk to clients, they sound extremely cautious," David Solomon, chief executive of Goldman Sachs, said this week. "Many CEOs are watching the data and waiting to see what happens."

The bearish sentiment is visible in the oil market's switch from backwardation — a market structure in which spot prices are higher than the price of contracts to deliver oil months in future — to its mirror opposite, contango.

This flip suggests traders perceive the market to be oversupplied, and the move is sometimes seen as an indicator of expectations for an impending economic slowdown.

The oil market's big worries centre on China and the US, the world's top two energy consumers. China's zero-Covid policy and weakening economy mean its total oil consumption this year will be lower than in 2021, according to the IEA, its first annual contraction this century.

While the US economy may escape recession, its consumers' thirst for petrol seems to have peaked too. Consumption for this time of the year has been this low only once before in the past two decades — in coronavirus pandemic-stricken 2020. Total US oil demand has not yet caught up to the pre-Covid era.

But prices could still rebound

Oil market bears think all this points to a cyclical unwinding of oil prices that lasts. But bulls are puzzled. They contend that years of supply under-investment will eventually catch up with the market if demand keeps rising, even modestly. Sluggish production growth in the US shale oil patch is another risk. Any decline in Russian supply may only be visible next year, argue some analysts. And China's weak demand will not last, they say.

"We basically are going from zero energy demand growth in 2022 [in China] to about 3mn b/d equivalent energy demand across the fuels next year," said Dan Klein at S&P Global Commodity Insights. "We're going to be seeing a lot more Chinese energy demand going forward."

Meanwhile, the government is winding down months of oil sales from its emergency stockpile, and plans to begin replenishing the stockpile if US crude prices drop to $70 a barrel. West Texas Intermediate crude settled at $71.46 on Thursday.

"At the margin, a seller of 200mn barrels in 2022 would become one of the largest buyers of oil in 2023," said Bill Smead, chair of Smead Capital Management, referring to the volume of emergency oil released this year. "History would argue that we have years of higher oil and gas prices ahead of us."

Additional reporting by Justin Jacobs and Myles McCormick