# Running out of storage

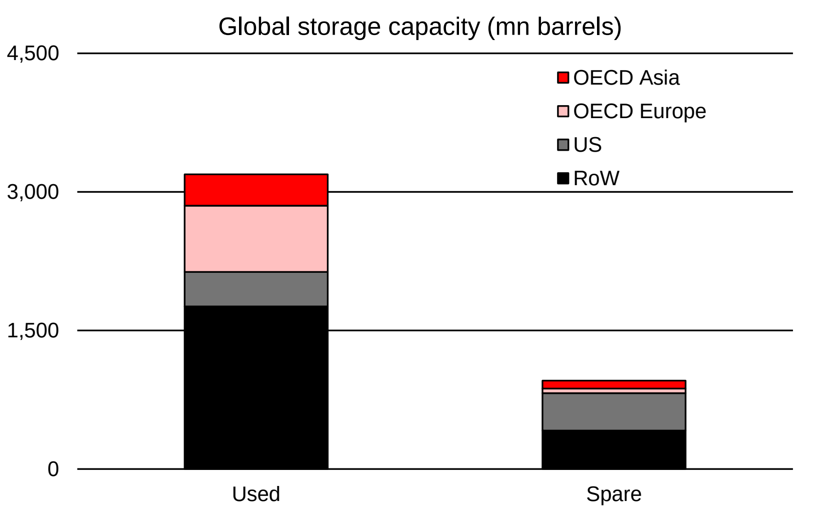
- The oil market is about to test its storage capacity limits as a result of a collapsing global demand and a frenetic pumping activity. By the end of May, the world might already run out of storage.
- A bold agreement to cut production is necessary to relieve prices and stabilize the physical market.
- We doubt that OPEC+ and other G-20 members can credibly commit to cut 10mn b/d (using April output as benchmark or 5mn b/d on 1Q20 figures). Curbs of 8mb/d are more likely and could stabilize Brent at around USD 35-40/bbl.

The world is awash with oil. The price war between Russia and Saudi Arabia, coupled with collapsing global demand amid the COVID-19 health crisis, has not only injected more barrels of oil into the market than the global economy can absorb but is also resulting in a surplus of crude oil that is about to exceed what tanks can store. This is the first time in history that oil producers are about to test the storage-capacity limits of the oil industry. Without a bold agreement that substantially cuts production for the rest of the year, there will be so much crude flooding the market that spot Brent prices are likely to plummet, even to USD 5-10/bbl, while futures will likely steepen as storage costs climb sharply.

### Reaching full storage capacity

Like any other good, oil also needs to be properly stored to preserve its quality. Storage tanks are meant to maintain pressure conditions and manage fumes and ventilation. According to Energy Aspects, global oil-storage capacity on land amounts to 4,200mn barrels, but only capacity equivalent to 956mn barrels is available (Chart 1). OPEC+ production in April is set to increase by at least 5mn b/d, as a result of expired cuts (2.1mn b/d) and a pump-at-will strategy imposed by Saudi Arabia. Assuming unchanged demand, it would take six months for the remaining storage capacity to be exhausted. However, with the COVID-19 outbreak taking a very heavy toll on economic activity, if one pencils in a demand contraction for 2Q20 of around 10mn b/d, by the end of May producers might no longer know where to place their barrels of oil.

**CHART 1: GETTING CLOSE TO THE LIMIT**

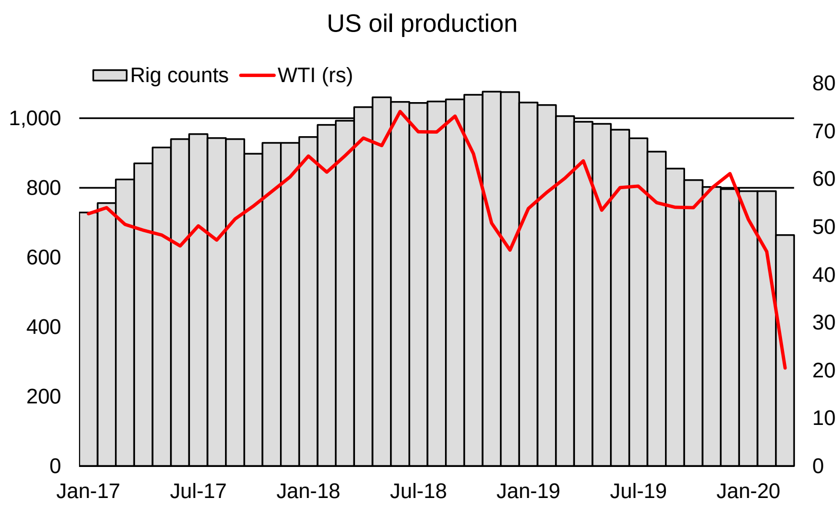



Source: Energy Aspects, UniCredit Research

It is difficult to envision any solutions to this problem. Floating storage on vessels is limited (currently around 70mn barrels of storage in this form is available), and it is becoming extremely expensive given high demand. Freight costs on large vessels have typically amounted to around USD 30,000-40,000 per day, but they have now increased to USD 110,000-400,000 day. Some oil is already trading around the world at a negative value, i.e. production and shipping costs exceed selling prices. Equally, strategic reserves are not an option either. According to the US Department of Energy, the country's Strategic Petroleum Reserve (SPR) currently contains 635mn barrels of oil out of a total capacity of 797mn barrels, while in China 400mn barrels out of 500mn of SPR capacity are already being taken. Such storage-capacity pressure is visible in the futures market, that is in contango – i.e. a barrel of Brent delivered in July, for example, costs USD 5 more than its spot price given rising storage costs.

When production approaches storage capacity, the oil price inevitably falls. It could even approach zero as the marginal value of each additional barrel of oil would be nil. There has even been speculation in the industry as to whether prices might become negative, imposing a de facto tax on producers who overwhelm the market. In such a scenario, the most rational reaction would be to turn off the tap. This is easier for countries with low operational costs, like Saudi Arabia, but also for many US shale producers. As shown in Chart 2, current dire market conditions have already led to a sharp decline in the rig count in the US. In other cases, however, such as in Russia, producers could be tempted to keep pumping at a loss rather than shutting down as well, as doing so might damage a reservoir or might prove less costly than reactivating production in the future. This implies that such producers might be willing to give away the oil they produce. Russia is also extremely vulnerable to storage-capacity constraints because, according to Bloomberg reports, it is only able to store just two weeks-worth of production.

**CHART 2: US PRODUCERS HAVE REVISED PRODUCTION PLANS**




Source: EIA, UniCredit Research

### OPEC+ deal

Amid this backdrop, tomorrow OPEC+, along with the G-20 members that are to be involved on Friday in a teleconference organized by Saudi Arabia, will have to deliver ambitious production cuts – not just to relieve prices but also to avoid a scenario in which storage capacity is exhausted. For sure, the involvement of countries beyond those in the traditional OPEC+ alliance will be welcome by the market, as it is, in our view, likely to be seen as an act of courageous coordination at such a difficult time. Therefore, we believe that incentives to avoid the collapse of the industry might prevail over concerns about quotas compliance when so many producers are involved – even considering how difficult it was for OPEC+ alone to enforce its previous agreements.

At the moment, it is unclear whether the group will use 1Q20 production figures or April figures as benchmark. As mentioned, this will make a big difference because, this month, production might increase by almost 5mn b/d as a result of expired curbs and Saudi Arabia's hawkish strategy. Riyadh is pushing for the use of April figures as a benchmark, because this would mean it would have to cut production less. Moscow, by contrast, has been asking that 1Q20 production figures be used. This is because it was close to full capacity already in March and only partly compliant with its quota. If Moscow gets its way, Saudi Arabia would bear most of the production-cut burden once again. Only if the April figures are used as a reference, the group has a chance to deliver cuts to the tune of 10mn b/d (or 10% of global production) as US President Trump requested last week. Cutting production by such an amount would not only address the extra 5mn b/d mentioned above but also absorb the 5mn b/d demand contraction that the US Energy Information Administration (EIA) announced yesterday for 2020. Announcing cuts deeper than these would lack credibility.

Let's have a look at the math of the 10mn b/d cuts more in detail. Around 5mn b/d would automatically come from OPEC+ to reestablish the output conditions that were in place by the end of March when the previous agreement was still in place. OPEC+ could still commit to cut production by around an additional 1.5mn b/d, as it was supposed to do at the beginning of March. So, we are left with 3.5mn b/d cuts that should come from producers outside OPEC+. Trump said that he does not want to interfere with market forces and Texas has still decide whether to introduce proration – due to anti-trust rules American producers cannot coordinate production among themselves, unless the federal or state governments impose a quota to comply with. Some output adjustment in the US is likely to happen spontaneously but not immediately. Yesterday, IEA said that over the next twelve months American production will decline by 1.5mn b/d. Probably, a too slow reduction given the current market conditions. Even including this move, we are left with production cuts of 2mn b/d that will have to be spread across the major producers. It is likely that some commitment in this sense will arrive, for instance from Canada or Norway, but will be hard to be enforced.

In our view, in the very short term the market could count on "real" production cuts of just 8mb on the April figures (or of 3mn b/d on the 1Q20 figures). And they should be enough to almost rebalance the market, likely pushing Brent into the USD 35-40/bbl range in 2Q20. This is our baseline scenario. Any cuts above this threshold will likely push Brent above USD 40/bbl, (before it becomes clear how unsustainable such commitments are) and anything significantly below (a low probability) these levels is likely to push Brent below USD 30/bbl once again.

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