Strategic petroleum reserves could curb oil price rise in the short term

- Oil market tightness persists following the OPEC+ decision to stick to its original production-cut tapering program and not accelerate the production of additional oil.
- Since the market is about to shift from a situation of undersupply to one of oversupply, the release of oil from strategic reserves could provide a bridge between these two phases, mitigating oil price pressure until more supply is released by traditional producers.
- To be effective, such a strategy requires a high degree of international coordination and needs to be limited in time given the emergency nature of these stockpiles. In order to bring Brent prices below USD 80/bbl, consumer nations should commit around 300kb/d for the next four months (that are equivalent to less than 1% of global strategic stockpiles).

The oil market remains tight. With demand growing faster than supply, OECD inventories continue to decline, supporting elevated prices. Despite pressure from several members of the G20, including the US and China, ahead of the OPEC+ November review meeting, the organization has refused to accelerate the tapering of its output curbs of currently 400kb/d every month through the end of 2021.

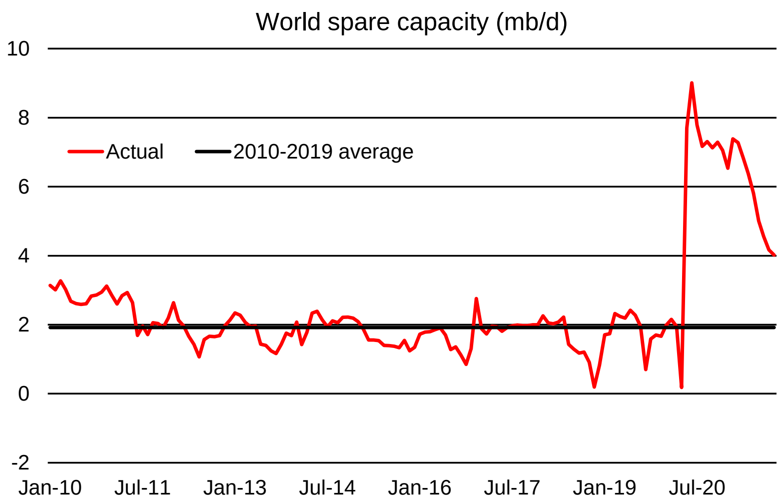
But as anticipated in our previous analyses, the market is close to a turning point. In early December, OPEC+ will convene for its annual meeting, at which it will announce its production strategy for next year. Currently it plans is to fully lift curbs by the end of the year, probably at the current pace. In the meantime, American production is surging faster than expected, as shale producers take advantage of high prices. As a result, the market is likely to shift from a situation of undersupply to one of oversupply already in 1H22. The releasing of oil from strategic reserves, as recently discussed by US President Biden and China's President Xi in their recent virtual meeting, could provide a bridge between these two phases, mitigating oil price pressure until more supply is released by traditional producers.

Still below capacity

When oil demand is particularly vibrant, the usual fear is that there is not enough supply to accommodate it. This is not the case today. Spare capacity – the volume of production that can be achieved within 30 days and sustained for at least 90 days – is the oil sector's ultimate shock absorber, going up and down depending on demand conditions and production strategies. Around 95% of the world's spare capacity is in the hands of four OPEC+ countries: Saudi Arabia, Russia, the UAE and Kuwait, with Riyadh holding the lion's share (around 30%). Hence, despite the flexibility of American producers in turning on their taps, the ability to address supply shortages rests on the political willingness of a handful of countries with their own political agendas and economic priorities.

As shown in Chart 1, spare capacity dropped in April 2020 when the price war between Saudi Arabia and Russia pushed WTI futures into negative territory as a result of the pump-at-will strategy and it reached a historical high two months later, in June 2020, when OPEC+ cuts of 9.7mb/d became fully operational. There is no perfect correspondence between the amount of frozen production and the increase in spare capacity because, in order to comply with a specific output quota, old wells might be shut down and new ones might not be activated, thus reducing the number of barrels that can be quickly and sustainably brought onto the market.

CHART 1: FROZEN PRODUCTION



Source: PIRA, UniCredit Research

Under normal circumstances, oil prices incorporate a risk premium when spare capacity is too low to allow the market to respond to demand shocks but also to potential crises that reduce oil supplies, like a war or a terror attack. During periods of large supply disruptions OPEC+ possesses the world's only readily available production to offset sudden losses elsewhere. Equally, when spare capacity is high and demand is fully satisfied, oil sells at a discount. Right now, the market is in a hybrid situation. Market tightness is largely artificial as production is not adjusting fast enough to accommodate demand, thus supporting high prices.

World spare capacity remains 2mb/d above its 2010-2019 level, largely driven by the OPEC+ curbs (Chart 1). Considering that the International Energy Agency expects oil demand in 4Q21 to increase by 1.2mb/d, this amount of overall frozen production is substantial. With favourable demand conditions, taking spare capacity towards its long-term average is necessary not just to balance the physical market but also to stabilize prices at levels that do not harm demand. This is something that we expect to happen in 1H22, as there seems to be a consensus within OPEC+ about the need to normalize production soon.

A last, temporary resort

In the meantime, strategic oil reserves, which consist in barrels stored in specific sites by a consumer nation and are ready for use, could provide some breathing room to the market. They represent a less conventional and less effective shock absorber than spare capacity as they come directly from the demand side of the market, and not the supply one. Unlike a supply-driven shock absorber, which can put barrels of oil where they are needed the most, a demand-driven mechanism can mitigate only local market conditions. Moreover, there is a limited amount of strategic stocks available and in some countries they are just enough to cover a few days of oil consumption. So, they can be seen only as a short-term fix. When a certain stockpile depletion threshold is crossed, oil prices might move up again, even if more demand is satisfied, because there would then no longer be enough barrels in reserve to address a future emergency. Passed that threshold, price mitigation can only come in the form of the injection of additional barrels into the market from producers.

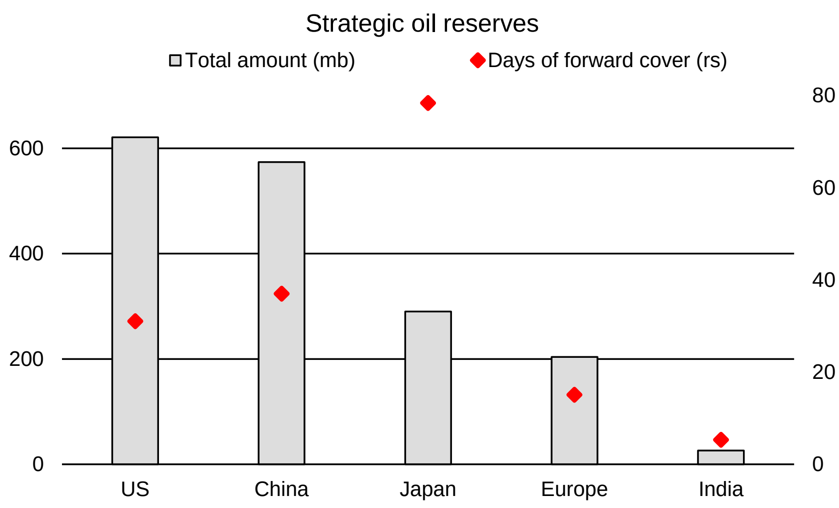
In the case of the US, strategic petroleum reserves represent an emergency tool that can be used when the country is faced with an economically threatening disruption in oil supplies and can be released under exchange arrangements (similar to loans) with private companies. Since 1975, when Washington created its strategic oil buffer, presidentially directed emergency releases have occurred three times, on the occasion of the Gulf War in 1991, Hurricane Katrina in 2005 and the Arab Spring in 2011. At least twice this year, and for the first time ever, China has tapped its own strategic stocks in an effort to bring domestic oil prices down and tackle the energy crisis that has led to power shortages in many parts of the country.

Globally stored barrels of oil held by governments amount to around 1.5bn bbl – or 4mb/d for one year, almost four times the expected demand increase in 4Q21. However, as shown in Chart 2, such reserves are unevenly distributed across the world.

The US and China maintain, in almost equal shares, around 70% of global strategic stocks and could accommodate domestic demand for around 30 days. Japan, on the other hand, has a forward cover of almost 90 days, while India just five.

Only a highly coordinated international move that leads to the drawdown of strategic reserves in several jurisdictions at the same time could have a significant impact on global oil prices. In this sense, a deal between Washington and Beijing, which are the two largest consumers in the world and the two largest holders of strategic inventories, on participating in a joint sale of reserves could succeed, even more so if the Biden administration manages to persuade other consumer nations such as India, Japan and South Korea to join in. Overall, to sustainably bring Brent prices below USD 80/bbl, the main consumers should commit at least around 300kb/d for the next four months (the top-up that the market roughly expected by the OPEC+) – that is equivalent to 36mb or less than 1% of global strategic stockpiles. If consistently carried out and well-communicated, and assuming no major changes in the output choices of OPEC+, such a strategy could bridge the next three to four months when demand-supply imbalances are likely to remain large.

CHART 2: UNEVEN DISTRIBUTION OF STRATEGIC RESERVES



Source: IEA, Bloomberg, UniCredit Research

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