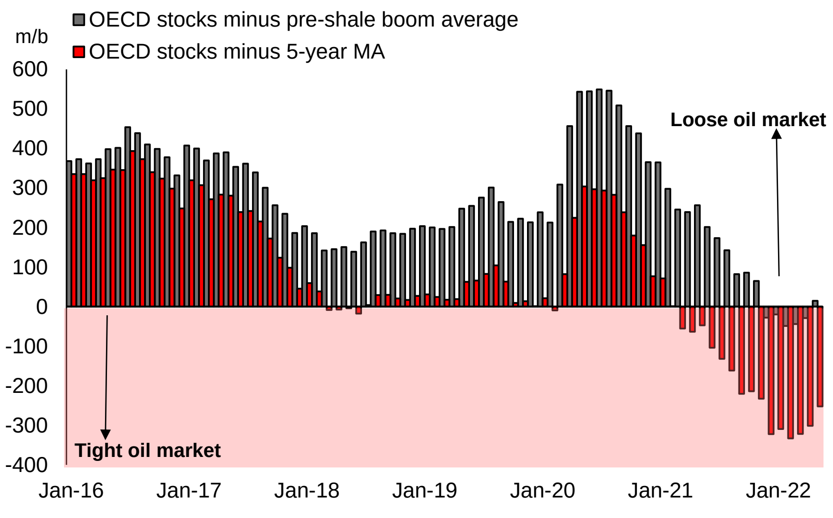
Oil prices likely to stay high for long

- The oil market remains extremely tight. Sanctions on Russian oil, OPEC+ production constraints and the stalled negotiations for an Iranian nuclear deal are likely to prolong the market tightness at a time of resurging post-pandemic mobility.
- Only the scrapping of OPEC+ quotas and the signing of an Iran deal would bring lasting price relief to the market. However, neither scenario looks politically realistic – at least for the moment.
- Upside risks to our forecast of oil prices declining in 2H22 towards USD 110/bbl have increased substantially. Brent might remain in the USD 115-125/bbl trading range for longer than originally expected, with potential spikes to USD 130/bbl.

Brent is again hovering around USD 120/bbl. The easing of anti-virus lockdowns in China, along with the partial embargo of Russian oil that was just announced by the European Union, has pushed oil prices to a two month-high. These factors add to the tightness of an already tight oil market (Chart 1). The expected shift from a situation of under-supply to one of over-supply by mid-year is now becoming increasingly unlikely – and not just because of the uncertainty caused by the Russia-Ukraine conflict. In its latest *Short-Term Energy Outlook*, the Energy Information Agency predicted that the oil market would remain broadly balanced for the next few months, but that supply would no longer exceed demand as it was forecasting until a couple of months ago. However, as we discuss below, this is a rather optimistic assumption at the moment.

Even if the degree of uncertainty remains extraordinarily high and there are several mitigating factors at play, such a tight market implies that upside risks to our forecast of oil prices declining in 2H22 towards USD 110/bbl have increased substantially. Regardless of mandated and voluntary sanctions on Russian oil, actual supply from OPEC+ producers is substantially lower than formal production commitments would suggest as a result of years of underinvestment and poor maintenance of existing infrastructure. Exempting Russia from the OPEC+ output deal and allowing other producers such as Saudi Arabia to pump more might bring some temporary relief to the market, but the lack of sufficient spare capacity represents an increasingly binding constraint at a time of resurging post-pandemic mobility. As a result, the probability of Brent remaining in the USD 115-125/bbl trading range for longer than originally expected, at least throughout the summer, has increased considerably, with potential spikes to USD 130/bbl.

CHART 1. AN UNDER-SUPPLIED MARKET



Source: EIA, UniCredit Research

Undersupply persists

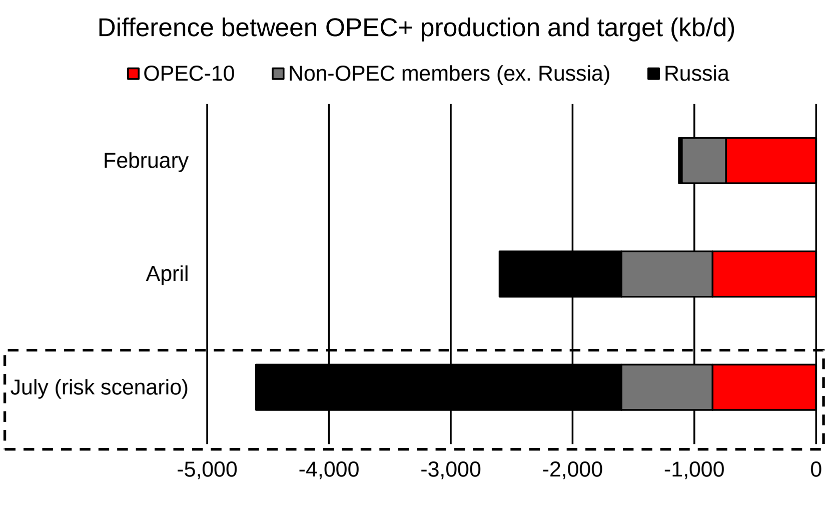
The oil market is currently around 4mb/d shorter (roughly 4% of pre-pandemic global production) than was we had expected in January. OPEC+ remains formally committed to increasing its monthly production by about 400kb/d, with the goal of completing the tapering of its output cuts by the end of the year. However, these formal production increases are not matched by an equal injection of new barrels of oil into the market. Chart 2 shows that the oil market is tighter than it would be if there were full compliance with production targets. In February, when the Russia-Ukraine conflict started, actual OPEC+ production was 1.1mb/d below target as a number of countries, in particular Nigeria and Angola, were unable to ramp up production due to problems with their oil infrastructure (Nigeria's pipelines are leaking and Angola's deep-water fields are in decline). The gap between formal quotas and actual production widened even further in April (the latest month for which data is available), jumping to 2.6mb/d, with Russia giving up 1mb/d because of Western sanctions and economic boycotting. Overall, this is as if the cartel had paused its tapering in November.

In addition, negotiations for an Iranian nuclear deal, which were proceeding well at the beginning of the year, have stalled since March, primarily because Iran insists that the US must remove the Islamic Revolutionary Guard Corps from its list of foreign terrorist organizations. At the beginning of the year, Iran, which has roughly 1.4mb/d of spare capacity, was expected to be a source of relief for the oil market if sanctions had been eased. With the mid-term elections approaching, the Biden administration might prefer to keep the negotiations on hold so that they do not become a contentious electoral issue. Therefore, the return to the market of the sanctioned Iranian oil might be further delayed. Overall, the OPEC+ missing barrels and the sanctioned Iranian oil amount to around 4mb/d.

Going forward, the situation is set to worsen. As boycotts and embargoes consolidate, Russia will be forced to cut its production as exports will fall and its storage capacity rapidly gets exhausted. According to the International Energy Agency, Russian production will likely drop by about 3mb/d by July – an amount equivalent to European imports of Russian oil. There might not be enough Asian buyers to replace Western ones, especially given the elevated insurance costs associated with shipping Russian oil, which have more than tripled since the beginning of the conflict. In addition, the sanctions included in the EU's sixth package that was announced at the beginning of the week include measures that would prohibit oil-related services, including insuring shipments to anywhere in the world. The implications are huge because most of the world's tankers are covered by the International Group of P&I Clubs. Since the organization ultimately buys reinsurance from European businesses, it would have to comply with EU law. Finally, with the Urals grade already selling at a USD 30/bbl discount to Brent, it is also in Moscow's interest to reduce production and contain the downward pressure on prices.

If one adds these output losses from Russia and assumes that the missing barrels from the other OPEC+ countries remain unchanged (chart 2), by July the cartel will be short of around 4.5mb/d – the equivalent of more than 11 months without tapering. In other words, overall OPEC+ production this July will be the same as it was last August. In reality, it will likely be lower, because with the exception of Saudi Arabia, the UAE and Iraq, all other OPEC+ producers have almost no more spare capacity and will be unable to boost production as much as needed in the next two months, meaning that the grey and red bars in chart 2 will likely be larger next July. For this reason, despite the mounting Western pressure to increase output, Saudi Foreign Minister Prince Faisal bin Farhan said in Davos that OPEC has already "done all it can" to stabilize global markets.

CHART 2. MISSING BARRELS



Source: IEA, UniCredit Research

Few mitigating factors

There are really few mitigating factors that can alleviate the tightness of the market. First, consumer countries are already releasing 120mn bbl from their strategic reserves. This is contributing to capping prices but responding to a potentially open-ended shortfall in oil production by providing a finite amount of supply is not a solution. Second, absent a major negative shock, demand remains buoyant thanks to the reopening of most economies and government interventions to mitigate the impact of higher energy prices. Third, American shale producers are investing in new fields, but these additional barrels of oil will not be available for at least 10-12 months.

The ball is really in the court of OPEC+. According to the *Wall Street Journal*, ahead of tomorrow's review meeting, the group is considering exempting Russia from boosting production as a result of Western sanctions. This would allow other countries such as Saudi Arabia or the UAE to increase their own production. Such a move would positively affect market sentiment and would further bring down prices, but it would be a short-term fix. A simple numerical exercise explains why.

Let's assume for a moment the most benign possible (but not politically realistic) scenario in which quotas are completely abandoned and OPEC+ members produce according to their production capacity. Overall, the spare capacity of OPEC+ (ex-Russia) is 4.2mb/d. If it was fully released overnight (practically complicated), it would barely compensate for the missing barrels expected in July, according to chart 2. But, at that point, OPEC+ would no longer be able to add additional barrels as it will have exhausted its entire production capacity. Considering that global demand is expected to rise by 2.2mb/d throughout 2H22 and non-OPEC+ production is expected to increase by around 1.3mb/d, then the world would be short of 1mb/d. Only a quickly signed Iranian nuclear deal could compensate for the shortfall and rebalance the market.

In short, under the current conditions, a balanced oil market in 2H22 coincides with an extreme scenario that would require a political will that we struggle to see at the moment. OPEC+ members might decide to allow more production flexibility to countries with higher spare capacity, but they are unlikely to abandon the quota system – simply because countries with no more capacity would see prices going down and their output staying constant while the overall revenues of their rivals would rise. In addition, scrapping the OPEC+ quotas would, de facto, imply the end of the enlarged cartel itself. At the same time, neither Washington nor Teheran look determined to finalize a nuclear agreement quickly enough to benefit the market. And even if there was the political will on both the OPEC+ and Iran fronts, most of the remaining spare capacity would require several weeks to be activated – and such delays would cause short-term price volatility. All in all, and considering the potential negative spillovers from the natural gas market when winter approaches due to the Russia-Ukraine conflict, the risk of Brent staying within the USD 115-125/bbl trading range for a longer period has increased substantially, with potential spikes to USD 130/bbl.

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