A new year, same challenges

In 2009, the crude oil market has tracked the ebb and flow of global stock markets and confidence - or lack thereof - regarding the end to the recession. However, with oil demand expected to pick up in 2010 and supplies remaining healthy, the short-term outlook for the market physically looks comfortable. This may be a welcome development for those homes and businesses that have seen large swings in their energy bills over the last two years given the volatility in the crude market.

Having slumped from $147 per barrel in July 2008 to $35 per barrel in February 2009, crude oil prices appear to have found some stability around $75-$80 per barrel – the market having traded around this point since the start of October 2009. The increase seen in price has been despite a continued pessimistic outlook for oil demand which – having reached 85.8 million barrels per day in 2008 – is expected to reach 84.8 million barrels per day (mbpd) in 2009 according to the International Energy Agency (IEA).

Supply, demand, optimal price and global recovery

As such, the year on year fall of 1.2% will be the largest annual decline since 1982. However, confidence over the state of the global economy has seen the IEA progressively increase its demand forecasts for both 2009 and 2010, with oil demand predicted to reach more than 86 mbpd in 2010.

Against this backdrop, supply availability will be crucial, and with oil producers' cartel OPEC having made successive official and unofficial cuts in its production throughout 2008, its members do have the ability to turn on the taps if needed. Following the cuts, OPEC members have a potential 5 mbpd of spare production capacity sitting idle, and could in theory make a corresponding level of production available to the global market.

Crucially in terms of prices, the group has already stated that it will consider increasing its output if needed and that an oil price above $80 per barrel in the current economic climate could harm the prospects for a recovery. Here, the group is walking a tightrope of wanting to ensure the optimal price for its output while simultaneously not wanting to harm any global recovery before it has fully taken hold.

The prospect of additional production capacity globally looks likely in the short term given investment projects that are in development and awaiting completion. This will prevent a repeat in 2010 of 2008's tight supply-demand balance, in the absence of any sustained production cuts or output difficulties. However, with oil prices increasing on economic confidence, the emergence of a sustained rebound in demand will fuel further increases in price.

Recession's impact on producers, suppliers and consumers

As Albert Einstein once famously said, "I never think of the future. It comes soon enough." This is a luxury that oil companies do not have, but consumers even less so, and the main long-term challenge in maintaining oil supplies will be the extent to which the recession has seen oil producers scale back their investment and the implications of this for prices. In other words, it is not enough to maintain supplies now - oil companies must take action now to ensure that they are maintained in the future.

Billions of dollars of investment was put on hold due to the recession, and while crude prices have rallied since the start of the year, there is no indication yet how companies will respond to the rebound. There is therefore a risk that investment cannot recover fast enough to meet any global increase in oil demand in the middle of the next decade, stimulating further and potentially sudden increases in prices and volatility.

For consumers, this means that while a return to the high prices paid for their fuel throughout much of 2008 does not seem likely, it certainly cannot be ruled out. Consumers do not have the ability to manage their spending in the way that suppliers do, and therefore caution should be taken when budgeting their likely fuel expenditure.

From a demand perspective, the two main sources of global oil demand growth – India and China – did not enter recession – at least according to the technical definition of two successive quarters of negative economic growth. At the same time, nations including the US and Germany have exited recession, although it remains to be seen whether this can be sustained. As such, the demand-supply outlook for oil looks well balanced for the coming months, with $80 per barrel appearing to be a balanced position in the market.

Climate change policy and the fuel market

Longer-term, the market for oil – as with all fuels – will be influenced by commitments on international climate change policy that are expected from the Copenhagen summit at the end of 2009. With energy efficiency standards for vehicles, homes and appliances all expected to be tightened over the coming years, this will restrict demand growth and hence the attractiveness of projects such as new oil fields, pipelines or refineries.

As such, 2010 looks on paper to have the potential to be a period of consolidation as far as oil prices are concerned – certainly compared to 2008 and 2009 – but the long-term outlook remains clouded and the potential for a global supply shortage cannot be ruled out.

Fuel Oil News would like to thank Dr Craig Lowrey, consultant at JCRA Energy for the above article.

How will the balance tip in 2010?