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Crude Realities in the Oil Market

A special report by the Portfolio Advisory Group

There's Wealth in Our Approach.™

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For Required Disclosures see page 5.
Priced in USD as of March 25, 2015, unless otherwise stated.

RBC Wealth Management
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Crude Realities in the Oil Market

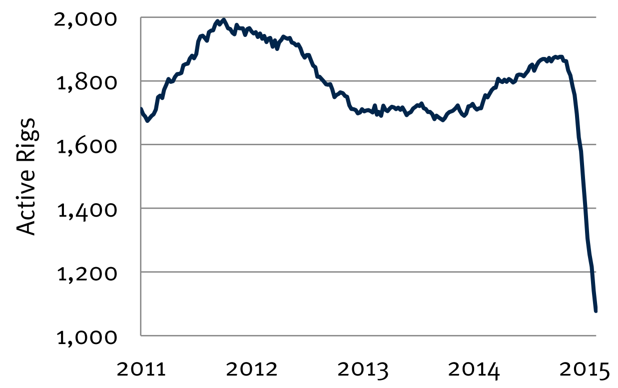
The dizzying rollercoaster ride in crude oil prices has continued in recent months. Falling U.S. rig counts led to optimism in February. However, storage capacity concerns and the possibility of an Iranian nuclear deal unlocking a flood of new supply weighed on sentiment in March. The supply adjustment process has just begun and will take time to play out. With these forces tugging the market in different directions, the bottom in crude oil prices is difficult to pinpoint.

Slash in Rig Counts Yet to Dent U.S. Supply Growth

Lower oil prices have led to a dramatic curtailment of drilling activity. Capital spending budgets are down approximately 35%–40% for independent exploration and production companies (E&Ps) and down about 10%–30% for international oil companies. The active rig count for U.S. onshore oil drilling has plunged 43% from its recent peak. Specifically, activity in major shale oil plays is down 45% in the Bakken (Williston Basin), 37% in the Eagle Ford, and 42% in the Permian.

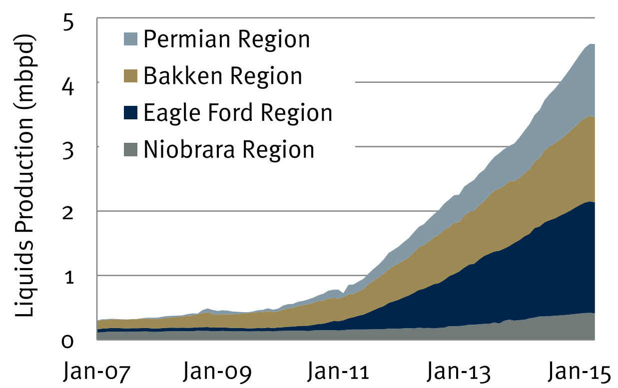
This is a positive and necessary step towards rebalancing the global oil market. However, it will take time before lower drilling activity translates into less production. Production growth continues from the major U.S. shale plays as legacy drilling is brought on stream and new drilling in the best quality rock continues.

U.S. Land Drilling Active Rig Count for Oil



Source - Baker Hughes; data through 3/13/15

U.S. Shale Oil Production



Source - U.S. Energy Information Administration (EIA), RBC Wealth Management; EIA provides forecast data for unreported months

Oil Storage Overflow?

Seemingly unrelenting supply growth has contributed to U.S. crude oil inventories reaching new multi-decade highs. In the week ended March 13, U.S. commercial crude inventories hit a whopping 459 million barrels. On a days-of-supply basis, U.S. crude stocks have ballooned to levels last witnessed in the 1980s. This inventory surge is prompting concerns over available crude storage capacity and the impact rising utilization levels could have on near-term prices.

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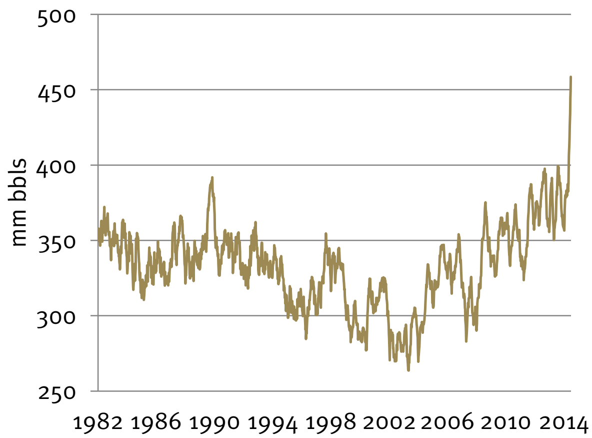
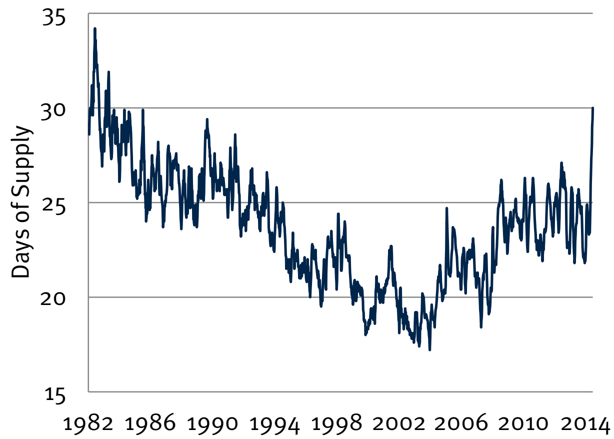
Weekly U.S. Crude Stocks and Days of Supply Since 1982



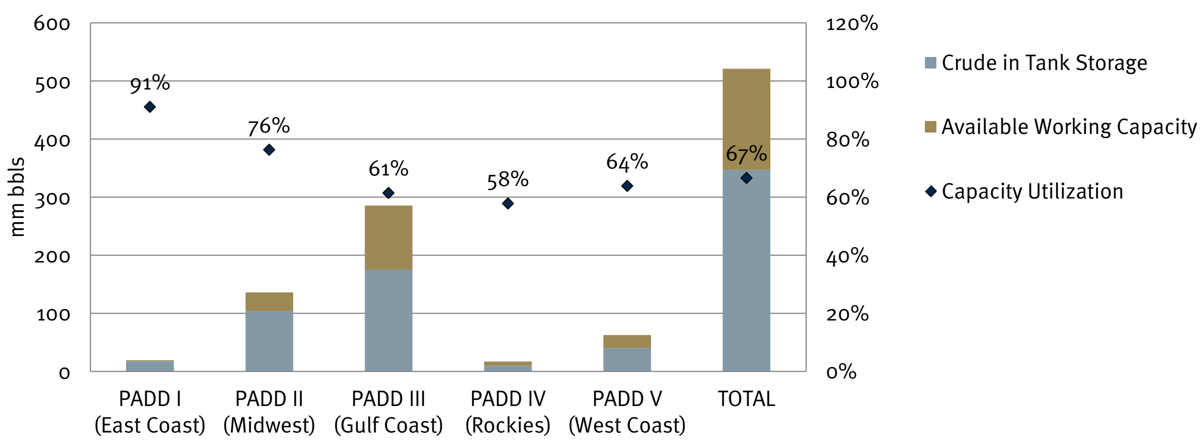


Source - EIA; data through 3/13/15

When assessing inventory and capacity figures, investors should be careful not to mix apples and oranges. For instance, one shouldn't compare U.S. Energy Information Administration (EIA) inventory levels to simple tank storage capacity. EIA inventory figures include crude located in both tanks and pipelines, while its estimate of storage capacity only factors in tanks.

For an accurate estimate of capacity utilization, inventory figures need to be adjusted for estimated pipeline fill, lease stock, and volumes in transit. Adjusting for these elements, a more accurate sense of storage capacity utilization at each PADD (Petroleum Administration for Defense Districts) emerges.

Estimated Storage Capacity Utilization by PADD



Source - EIA, RBC Wealth Management; data through 3/13/15

It also bears noting that the capacity utilization figures outlined above are likely conservative in that they underestimate total storage capacity available for two main reasons: (1) the EIA's tank storage estimates were tabulated in September 2014 and new facilities have likely come into service since that time; and (2) the storage estimate doesn't account for crude located in floating storage (i.e., offshore tankers), on barges, or in rail cars.

We are paying close attention to the inventory accumulation in PADD II, where Cushing, Oklahoma is located. Cushing is a critical hub in the North American oil market, given its status as the delivery point for contracts linked to the WTI benchmark. A crude glut at Cushing can have an outsized impact on near-term prices.

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That being said, infrastructure constraints at Cushing have been greatly alleviated by recent pipeline projects. The reversal and expansion of Enbridge's Seaway Pipeline and TransCanada's Gulf Coast Pipeline have contributed much-needed crude outlet capacity from the region to the U.S. Gulf Coast. Should storage utilization continue to climb (with presumably upward pressure on local storage rates), we expect differentials in time and location will likely adjust and, unlike when infrastructure constraints were more pronounced, crude will be able to flow elsewhere.

Investors should keep in mind that the ongoing supply growth has occurred at a difficult time for the market to absorb it. At this time of year, U.S. refineries typically run at reduced utilization rates due to planned seasonal maintenance ahead of the summer driving season. Exacerbating the situation, certain refineries have endured unplanned shutdown and workforce strikes.

A seasonally driven return to higher utilization rates in April and through the height of summer, along with an improvement in unplanned downtime, would help alleviate swelling U.S. inventories. Progress on the refinery strikes, which resulted in 6,500 union members off the job at its peak, appears to have been made with the broad strokes of a resolution agreed to in mid-March.

Iran Nuclear Negotiations

Muddy the Outlook

Negotiations between Iran and the five permanent members of the U.N. Security Council plus Germany (P5+1) are working towards a framework agreement concerning Iran's nuclear program. The P5+1 would like to see Iran reduce its stockpile of enriched uranium, cap the number of operational centrifuges, and allow for more thorough inspections of its nuclear facilities.

Iranian Oil Production

Source - Bloomberg; data through 2/28/15

Iran wants the U.S. and EU to lift sanctions so that it can export more crude oil. If this occurs, industry analysts estimate that 0.5–1 million barrels per day (bbl/d) of additional exports from Iran could hit the market. The timing of the ramp-up in exports could be constrained by either legal or operational challenges. If restored quickly, an additional 1 million bbl/d of supply into an already oversupplied global market would swiftly deepen and potentially lengthen the oil rout.

Conclusion

The price of oil has been weighed down recently on rising storage figures in the U.S. and concerns around new production from Iran. The rebalancing of the global oil market has started, but it will take time for production growth to slow. While the storage situation should resolve itself eventually, it could lead to acute pressure on oil prices in the near term. Should a nuclear deal be struck with Iran, this new flood of supply could lead to a deeper and more protracted trough in oil prices.

RBC Capital Markets forecasts average prices for WTI crude oil of $41.50/bbl in Q2 2015, $55.31 in Q3, and $70.16 in Q4. Near-term prices will likely be driven by catalysts such as talks with Iran, any reaction from OPEC, storage capacity concerns, and other supply-side wild cards (e.g., Libya and Iraq).

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