Oil Hits Another Slick Patch

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Once again history was made as U.S. crude oil futures plunged below zero for the first time in known history on Monday. The price of a barrel of West Texas Intermediate crude (WTI) for May delivery fell from Friday's price of $18 to negative $37.63 during Monday trading. This implies that instead of sellers receiving payment for their barrels of oil, they would be expected to pay the buyers to take delivery of their oil.

Admittedly, I watched the screen with shock and awe as I saw the May oil price contract hit the $10 level and then continue to fall below zero on its way towards steep negative territory. The cause of the freefall in the oil price contract was due to the limited capacity of storage to hold all of the produced oil that is now unused by the economy. This is why the better indication of the oil market is the June contract, which also experienced an 18% decline, although pricing held above $20.

Production cuts - too little, too late

Recently, oil was given a temporary boost from a deal to cut production by OPEC+ (OPEC plus Russia) by approximately 10 million barrels per day, or 10% of global production. The largest production cutback in history was an incremental positive for the beleaguered sector, but viewed as insufficient to offset the collapse in demand from the COVID-19 induced economic slowdown. Demand destruction is estimated at between 25 to 35 million barrels per day.

Timing was also an issue with the recently announced production cuts to take place in May because of the time required to shut in productive wells. This meant that production at levels well beyond demand continued for the past six weeks despite the cratering in demand for oil due to idled factories and grounded airplanes.

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Where to from here?

The global energy industry is in turmoil from this economic downturn. This is of particular interest here in Canada given the importance of the health of the sector to our economy. In recognition of this fact, the Canadian government recently announced $2.5 billion in support for the hard-hit Canadian oil and gas industry as well as financial support and liquidity for companies through the Business Development Bank of Canada (BDC) and Export Development Canada (EDC). There is potential for more industry support for the Canadian sector in due course.

Although the negative pricing of the futures contract is likely to be a temporary phenomenon related to the timing gap between the current freefall in demand and a lag in production cuts, volatility in the price of oil is expected to remain alongside COVID-19 related uncertainty. Some producers have announced plans to shut-in production but we will need to see a more widespread commitment to reduce supply. Capital expenditures will also continue to fall, impacting potential future production. This will eventually help to alleviate the current supply and demand imbalance and down the road, after the current economic shutdown, may set up a strong recovery for the price of oil and the energy sector.

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