Our View: $40 per Barrel Crude?

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Could crude oil prices fall to $40 per barrel in 2023? The skeptic in the back of one's mind shouts, "No, that is not possible!" After all, we have been told that "oil demand will continue to increase, helping send crude prices to $80 to $100 a barrel later this year."[1]

Five weeks after the unexpected production cut announcement from Saudi Arabia and Russia, the situation has changed noticeably. Bloomberg observed that refiners in Asia that cannot obtain discounted Russian crude might cut their runs and that refiners in Europe may do the same as the latter sometimes lack access to market-priced crude.[2]

In recent months, countries that have ignored the EU ban on importing Russian products have purchased products from Russian refineries at prices significantly lower than in world markets. Brazil has been a primary beneficiary, as Argus Media reports:

> The presence of Russian diesel in Brazil has expanded thanks to its lower cost, a price drop caused mainly by sanctions applied by G7 member countries and the EU. Russian diesel is being offered at around 30¢/USG below US Gulf Coast product. At least six companies operating in Brazil are working with Russia and at least one major importer should receive between two and four vessels this month, sources said.[3]

The thirty cents per gallon discount equals $12.60 per barrel before transportation costs, a substantial incentive that is luring Brazilian buyers to purchase Russian diesel when they can.

Refiners in the United States have had to respond. As the Argus commentary observes, "US suppliers have lowered their prices to Brazil and other South American markets in recent weeks to maintain market share, a move that caught the eye of buyers unable to negotiate with Russia."

In fact, over the last sixty days, the distillate price quoted for delivery on the US Gulf Coast has declined by thirty cents per gallon.

The decline in diesel prices tied to increased Russian exports and the exports from India and the UAE to Europe that have depressed diesel prices have also depressed crude prices. Further declines in diesel prices tied to Russian dumping of the product will lead to lower crude prices.

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[1] Mitchell Ferman, "Pioneer's Incoming CEO Sees Chance of Oil Hitting $100 This Year," Bloomberg, April 28, 2023 [https://tinyurl.com/36pu4tve].

[2] Sharon Cho and Prejula Prem, "Russian Oil Binge Becomes a Problem for Refiners Who Miss Out," Bloomberg, April 27, 2023 [https://tinyurl.com/2rjsz7e6].

[3] Gabrielle Moreira, "Russian diesel entrenched among Brazil importers," Argus Media, May 4, 2023 [https://tinyurl.com/mry5e59r].

The diesel price drop will not be offset by higher gasoline prices. Higher interest rates and bank liquidity issues are leading to the liquidation of gasoline inventories. Gasoline prices will fall.

This raises the possibility of a large crude price decrease in the coming months, especially as high interest rates add pressure to reduce inventories. Given these circumstances, the skeptic might reconsider and say, “Yes, crude could easily fall to $40 if—and this condition is important—Russia keeps dumping discounted diesel into the global market.”

Continued Russian dumping will depress product prices, and crude prices will follow. The situation is somewhat like the US banking crisis. Many banks saw their depositors flee out of fear of closings. Today, independent refiners, particularly in the United States, will walk away from crude markets, fearing further product price declines and worrying they will suffer large losses if they buy high-priced crude.

This conclusion mocks a Bloomberg commentary that began this way:

> Crude markets have suffered a disastrous few weeks, dragged down by alarm over the wider economy. But real oil demand still looks strong enough to foster a rebound in prices.[4]

The authors continued,

> There are signs the underlying oil market is resilient. China is sucking in a flood of cargoes as domestic travel rebounds, and traders expect the country’s crude purchases to remain high in the next few months. Inventories are tightening around the world, and should deplete even faster as Saudi Arabia and its OPEC+ allies implement new supply cutbacks.

The Bloomberg report was titled “The Real Oil Market Shows $20-a-Barrel Price Collapse Is Excessive.” The authors evidently failed to talk to the refiners that buy the crude and will see only losses if crude prices rise.

Investors, on the other hand, have gotten the message. Share prices of the BP Prudhoe Bay Royalty Trust have declined steadily, as the figure on our web page shows. WTI prices are following.

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[4] Alex Longley, Grant Smith, and Sharon Cho, “The Real Oil Market Shows $20-a-Barrel Price Collapse Is Excessive,” Bloomberg, May 4, 2023 [https://tinyurl.com/99upzx3t].