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U.S. HEATING OIL AND THE WORLD OIL MARKET: A SHORT-TERM OUTLOOK

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To

Winter Fuels Outlook Conference

Sponsored By

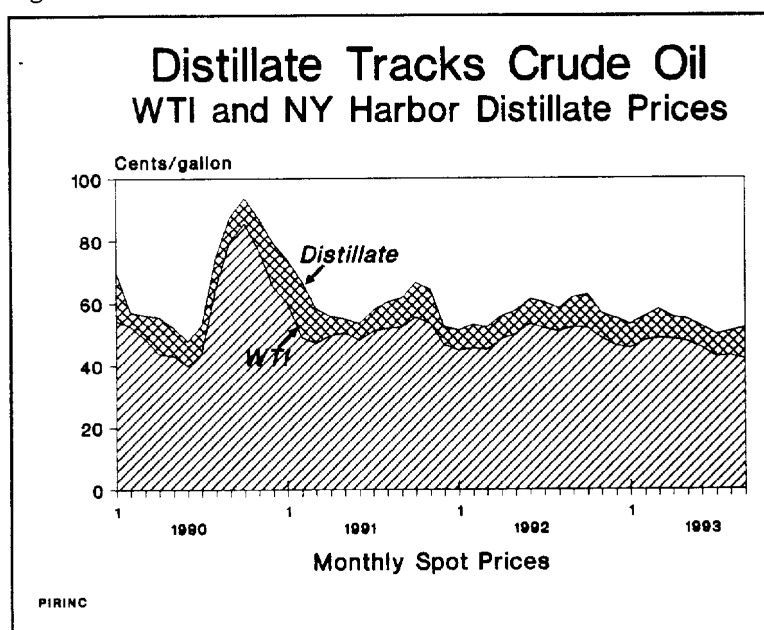
U.S. Department of Energy and
National Association of State Energy Officials

Washington, DC

October 19, 1993

Why do we need a global perspective of the winter season for domestic heating oil. The principal reason is of course that U.S. heating oil prices track crude oil prices very closely and consistently. Figure 1 shows this close relationship quite clearly. Since the cost of crude to refiners accounts for 70-75% of the wholesale price of distillate heating oil, and since crude oil prices are determined internationally, U.S. distillate prices are bound to be significantly affected by world crude oil market conditions.

Figure 1



Another reason for this international connection is U.S. foreign trade in distillate oil. Figure 2 shows that the U.S. last year was about balanced in imports and exports of this product (220 MB/D). However, all imports came to PAD I (East Coast) while all exports came from PAD's III (Gulf Coast) and V (West Coast). During the last heating season, some 15% of distillate supplies in PAD I came from abroad. But nearly all of it came from just 3 sources (Figure 3): The Virgin Islands, Canada and Venezuela. The Virgin Islands is a foreign supplier in name only since it is a U.S. territory. Canada has no other foreign outlet for oil products, but Venezuela does and, of course, U.S. distillate exports from PAD III rise and fall with foreign requirements relative to U.S. requirements. So, the world distillate market does have an impact on short-term U.S. distillate prices. However, the impact of world crude oil prices is generally a more important and pervasive factor.

Figure 2

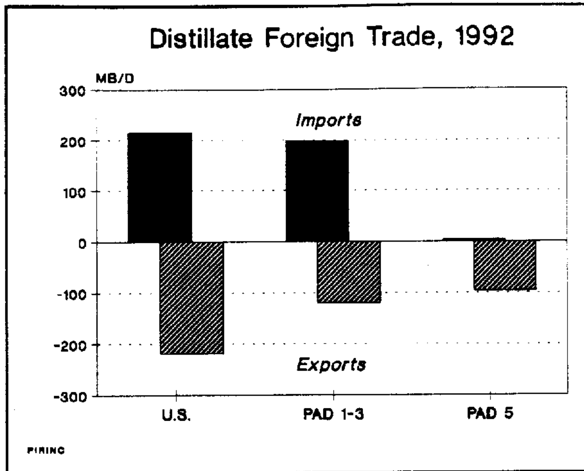
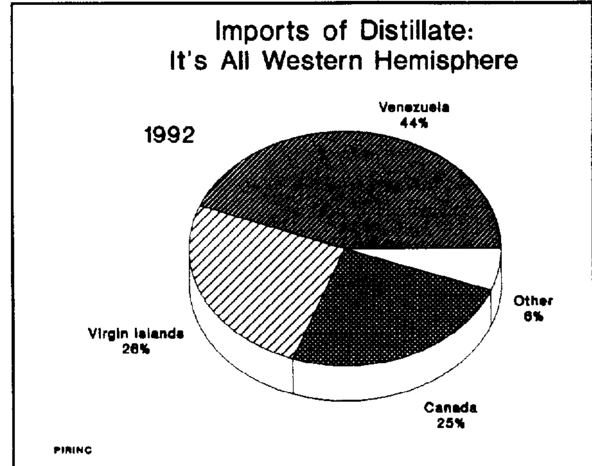


Figure 3



So, let us now look at the world oil market. Figure 4 shows a slow but steady increase in total world oil demand as well as middle distillates. Figure 5 shows the annual changes during the last five years including 1993. As you can see, there has been steady growth in world middle distillates demand.

Figure 4

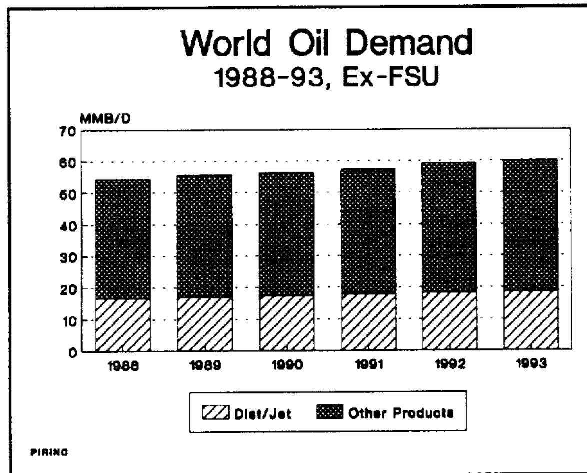
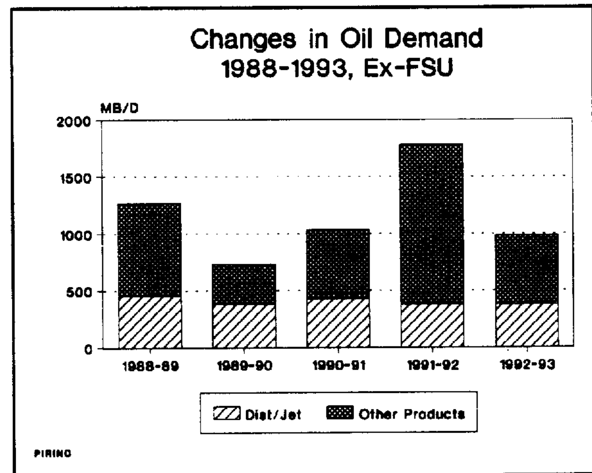


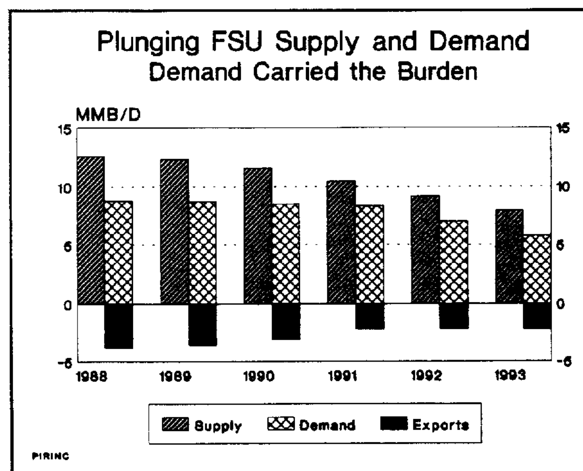
Figure 5



Let me point out that these figures exclude the former Soviet Union (FSU). If you were to look at total world demand, including the FSU, you would see a different picture because FSU demand has been declining at a cascading rate, as Figure 6 shows. But so has FSU production. The balance which concerns the rest of the world are FSU net exports. These have been steady for the last three years. Hence, the radical declines in FSU production and consumption since 1991 have had little impact on the rest of the world oil market.

Where do we stand now regarding the near term world crude oil market. Last month's OPEC meeting in Geneva prevented a further price decline and caused, so far, about a $1.00 increase in crude prices. However, prices are still some $4 below the year-ago level which at the time was not perceived as unusually high.

Figure 6



A price increase following a successful OPEC meeting had been expected, just as a sharp price decline would have occurred had there been no credible agreement. The recent post-Geneva price reversal is somewhat unexpected but reflects marketers' and traders' confidence that there is plenty of oil for the heating season and beyond. They are likely to be right. World oil stocks are about in line with last year which is clearly adequate for such eventualities as somewhat colder weather or modest disruptions of supply.

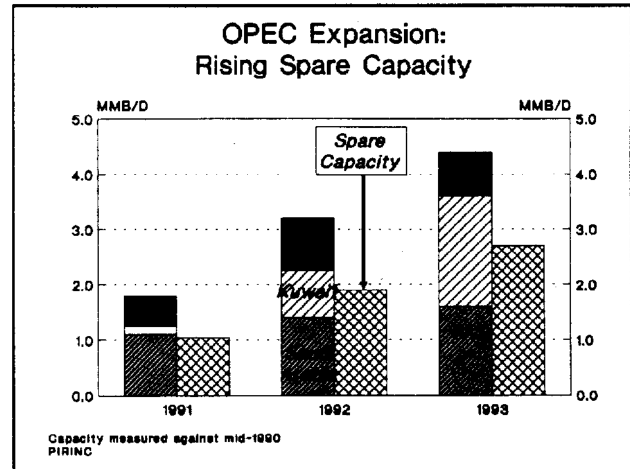
Right now we are actually seeing an increase in non-OPEC supplies, principally the North Sea (some 700-800 B/D) but also the U.S. While total U.S. production is down from a year ago it is up by about 100 MB/D from the 3rd quarter level, primarily because of a rise in Alaskan production. This is of course not a reversal of the long-term decline in U.S. oil production but it adds to the temporary oversupply.

The balance in world supply has to be set by OPEC whose self-imposed role is to be the world's marginal supplier. OPEC's quota for the next 6 months has been set at 24.5 million B/D. It will probably produce slightly more, but nothing like its 3rd quarter overproduction. There are several reasons. The most important relates to Iran, OPEC's principal quota violator in the 2nd and 3rd quarter. At its current quota of 3.6 million B/D, Iran is probably very close to its sustainable physical capacity limitation. At its previous quota of 3.3 million B/D this was clearly not the case. There are also signs that Iran, for political reasons, may be more willing to abide by its quota now than in the recent past. Nigeria, the second largest quota violator in the 3rd quarter, also appears to have some production problems which make it less likely that it will significantly exceed its quota. Then there is Saudi Arabia, OPEC's giant which accounts for almost 1/3 of the 12-member organization's total production. Saudi Arabia has kept quite close to its 8 million B/D quota in the 3rd quarter and there are no indications that, given the same quota for the next 6 months, its policy will change. So altogether, OPEC may for once stick quite closely to its quota, at least for the next several months.

But as we approach the 2nd quarter of 1994 (which for the market begins in February), world oil demand will seasonally decline, perhaps by 2.5-3.0 million B/D and OPEC will have to cut production to protect its price level. The question is who will do the cutting? The

answer does not get any easier from year to year despite a secular growth in the demand for OPEC oil. The reason is that OPEC faces a continuing growth in spare capacity. This can be seen in Figure 7. It shows that in 1993 the principal contributor to the growth in OPEC capacity was the resumption of Kuwait production. In 1994 it may well be Iraq, although probably not in the lst half. However, as we know, the market is very sensitive to even the vaguest sign of an approaching end to U.N. sanctions or any other change in U.N. policy on Iraqi oil exports.

Figure 7



In summary, then, the world oil outlook for the winter season is that there will be sufficient oil available to maintain relatively low prices, probably below last year's, but there is unlikely to be a price collapse since OPEC is capable and appears determined to prevent it. So, to the extent to which U.S. heating oil prices are determined by world crude oil prices, this should be a fairly easy winter for heating oil customers, assuming, of course, no sustained major weather abnormalities or other major extraneous disasters during the next 4-5 months.