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OIL PRICES GO NEGATIVE: WHY, HOW AND WHAT NEXT

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Monday 20 April saw one of the more extraordinary moves in oil markets in recent years, with the price of oil – one month forward West Texas Intermediate (WTI) – falling into negative territory, at minus $37 per barrel. While it rebounded in early morning trading the next day, oil prices generally have remained very volatile.

A brief guide to oil prices

While the headline takeaway seems fairly simple, we need to dig a bit deeper to understand negative oil prices. Importantly, this fall into negative oil prices was very specific to one contract for the delivery of physical oil. There are different price benchmarks for oil depending on where you are in the world with WTI a regional, landlocked measure of prices in the US.

The most common measure of global oil prices is Brent crude. This is what you will often see referred to in the mainstream media or BBC as it is the main internationally traded benchmark for oil, rather than the regional one WTI represents. What you will probably see in newspapers and on the media in the next few days is about WTI, however, because it is that particular oil price which fell into negative territory.

Importantly, the price of oil also fluctuates depending on when it is to be delivered, i.e. in a month's time or two months' time. The price of a barrel of oil for delivery today is known as the spot price while the price of oil for delivery in a month's time is known as the one month forward price. It is the price of one month forward WTI which fell sharply into negative territory on Monday evening.

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Why did the price turn negative?

This was very much about a specific contract for the physical delivery of oil. With the glut in US and global markets, very few people want to take physical delivery of oil right now, with storage capacity close to running out. That likely triggered a lot of panic selling, turning the oil price for one month forward WTI sharply negative.

At current production, the US has around two to three weeks' storage capacity at its facilities in Cushing, Oklahoma, with a further six weeks' storage on hand across the country. Cushing is the most important storage location for setting the price of WTI, so people scrambled to avoid being physically presented with a barrel of oil as it filled up.

The broader issue is the oversupply of oil – both in the US and globally. There are around six to eight weeks of storage capacity outside of the US and both India and China have talked about opening their Strategic Petroleum Reserves to take advantage of low prices. But the bottom line is that oil producers need to cut production, with an agreement between OPEC and Russia, led by Saudi Arabia, unlikely to kick in fully until mid-May. Until we get past that point, the oil market will likely remain at its lowest ebb, although forecasting any turning point with precision is virtually impossible.

What happens next?

Ultimately, we could see a repeat of this situation next month, with the price for physical delivery of WTI again turning negative as storage capacity remains under pressure. A lot will depend on how quickly companies can cut production.

Oil prices will remain weak, although the IEA does expect demand to recover over the second half of the year. Oil producers will undoubtedly be forced to cut production, either because their costs of production are too high, or simply because they are forced into bankruptcy. With the exception of shale oil, it is not easy to restart production from an oil well, so there is even a risk over the medium to long term that we actually end up with a shortfall in global oil supply.

The impact of the WTI saga on oil producers themselves is unclear because it depends on their involvement with the contract. As well as potentially being on the wrong side of events, it is possible that some producers will have profited from the turbulence. However, they tend to be very guarded about giving away performance numbers until company results later in the year. Historically, trading in the futures market can lead to oil companies surprising investors – for better or worse – but without any real lasting effect.

Investors in oil producers will probably refocus on dividends over the coming weeks and months. Several of the oil majors (Royal Dutch Shell, BP and Total) are due to report results at the end of April. For the meantime, we do not expect Shell or Total to cut their dividends, and while there has been some speculation that BP will cut its dividend, it does not necessarily have a financial need to do so. Regardless, the oil market will continue to hold people's fascination for some time to come.

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