How the oil price can slip to $0

And why petrol prices take longer to drop

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An oil drilling facility in Texas. West Texas Intermediate (WTI) and Brent are the two most commonly used crude oil grades. The April 20 negative oil price refers to the WTI futures contract for May delivery. The prices of WTI for later months, spot oil and Brent crude were above zero on that date due to differences in delivery obligations and trading methods. PHOTO: REUTERS

The global oil market witnessed a doomsday scenario on April 20 when the price of US crude oil futures – which had never fallen below US$10 a barrel – plummeted to an unimaginable negative US$38 a barrel. The unprecedented fall of more than US$50 per barrel within a day sent a shockwave throughout the global markets.

The oil prices have since rebounded. Market sentiment, however, is still fragile and oil price continues a volatile trajectory.

How could the price of a vital commodity – long viewed as "the blood flowing through the veins of the world" and remaining as a crucial source of energy – ever become negative? What are the implications for oil consumers, investors and economic outlook?

HOW IS CRUDE OIL PRICED?

The pricing of oil is a complex matter because it is determined not only by demand and supply but also by crude quality, trading method and delivery option. West Texas Intermediate (WTI) and Brent are the two most commonly used crude oil grades. They are known as "sweet crude" because their sulphur content is less than 1 per cent.

WTI is the benchmark for North American crude oil while Brent is used to price crude from the North Sea.

Unlike gold, the spot market for oil is not active as most investors do not want to take physical delivery of oil whenever they trade. As a result, oil is traded primarily through futures contracts, which specify a settlement price for delivery in forthcoming months.

WTI futures are listed on the New York Mercantile Exchange while Brent contracts are traded on the Intercontinental Exchange in London.

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WHAT CAUSED NEGATIVE PRICE?

The breakdown of the talks between Saudi Arabia and Russia in mid-March triggered an oil price war. Two of the world's largest oil producers flooded the market with excess supply, causing a 50 per cent drop in price since the beginning of the year.

To make matters worse, the ensuing worldwide lockdowns due to the Covid-19 pandemic cut down the crude demand so drastically that the world was quickly running out of crude storage capacity.

On April 20, traders of WTI May contract were facing the obligation to take delivery of the crude at the Cushing hub in Oklahoma, with the contract expiring the next day. As the Cushing facility was approaching its storage limit, and crude cannot be disposed of freely because of environmental impacts and regulatory constraints, those traders who became so desperate to avoid that obligation were willing to sell their contracts at any cost.

Negative price is an extraordinary way for the market to send a signal of massive excess oil supply.

HOW DOES NEGATIVE PRICE AFFECT CONSUMERS?

A crude price crash does not immediately result in a drop in petrol price or free petrol. This is because the inventory of petrol is built up over a long period of time and refineries engage in various tools such as oil derivatives to manage short-term price volatility. In the long run, a sustained low crude price will be reflected eventually in a low petrol price.

Price impact is also determined by consumer geographic locations. For instance, residents of Texas where crude is produced and refineries are operating enjoy lower petrol prices than people living in California.

Will airlines benefit from the price plunge? Maybe, but not immediately. To manage fuel price risk, airlines generally use futures and hedging strategies to lock in fuel price in advance. Therefore, the flash clash in mid-April – followed by its quick recovery – may not necessarily translate into lower fuel price unless the crude price remains low in the future. Given an unprecedented oil glut, there is a good chance that cash-strapped airlines will benefit from a much-needed low fuel price when they start to operate flights again.

BLACK SWANS ON THE HORIZON?

The worst of the coronavirus pandemic appears to be over for many countries, with many places starting the process of reopening their economies. Riding on growing optimism, the global stock markets have rebounded forcefully since their March lows. So have oil prices. But the risk of a second wave of infections is clear and present. "I'm almost certain it will come back, because the virus is so transmissible and it's globally spread," warned Dr Anthony Fauci, the top infectious disease doctor in the United States. Chinese medical experts rang the same alarm bell recently.

Should the consequences of the second wave turn out to be as deadly as some experts have feared, lockdowns may be reimposed. The crushing effect on oil and stock markets could ensue.

Another systemic risk is the upcoming presidential election in the US. Should Sino-US relations – already severely strained by the trade war and the virus pandemic – deteriorate considerably, the unthinkable scenario of a US-China decoupling may become a reality. Economic disintegration, tantamount to self-harm to both the US and China, would put the world economy in grave danger.

What does it mean for investment opportunities? The energy sector of the S&P 500 is a clear disaster so far this year, with the WTI plummeting nearly 70 per cent and Brent crude plunging by about 60 per cent. The devastation has spared no one.

Oil giant Exxon Mobile just reported its first quarterly loss in three decades on collapsing oil prices. And the International Energy Agency in its April report predicted that the pandemic would cause global oil demand to drop to levels last seen in 1995.

Although it is anyone's guess when the pandemic will end and how fast the economic recovery would be, we do know the risk will eventually go away. Oil demand will pick up again, perhaps gradually. The supply side will also adjust after many of the debt-laden shale and oil companies are wiped out or have consolidated.

For those keen to gain exposure in the sector, this oil crisis could be an unusually attractive opportunity to pick up high-quality players with very attractive valuations.

In conclusion, the negative oil price is a temporary phenomenon sparked by supply glut and storage constraint. The lower crude price, if sustained, could translate into lower pump prices at petrol stations and lower jet fuel for airlines. While there is a wide range of scenarios for how the pandemic will evolve, long-term-oriented investors who are mindful of potential systemic risks could find some attractive investment targets.

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