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Opec sees vindication for accord on production cut one year on

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ALMOST one full year after Opec's landmark decision to hold production at 32.5 million b/d, oil prices crossed a significant upward barrier, with the December ICE Brent crude oil contract breaching $60/b in the last days of October this year, up almost $10 year on year.

Then, Opec members and 10 non-Opec producers led by Russia, committed to cut a combined 1.8 million b/d from the market, in a bid to lower record high crude oil inventories. The initial six-month deal was extended in May this year to March 2018.

Despite unrelenting US production and five-year average highs in global oil inventories, a consistent even if pockmarked effort by Opec countries to rein in monthly production and exports seems to have convinced the market that had been trading in a $50-$55/b range for the majority of the previous quarter.

Earlier in August, supply shortages on the back of weather conditions in the Pacific Ocean had already tipped the balance of oil fundamentals in favor of a bullish outlook as the Brent crude oil futures structure flipped into backwardation - a market condition where the prompt price of a commodity is valued higher than its price in the future.

OIL INSIGHT

Backwardation generally means the market is willing to pay more to receive oil now rather than later, and highlights shortage or urgency of the commodity in question.

The last year has seen fierce competition between oil producers from the Opec, non-Opec bloc as well as from US sources, and Asia has taken center stage in terms of buying activity. However, the backwardated market structure and resurging oil demand from Europe and the US has resulted in rising costs of delivering non-Asian arbitrage crude - such as grades from South America or Western Africa - to Asian refiners, who have been left to contend with proximal choices such as Middle Eastern, Russian or Southeast Asian crude barrels.

A key consideration at this time that is vividly different from last year is how regional Asian crude term contract negotiations will proceed. The outlook was bleak for producers last year, with plenty to doubt about the success of an Opec cutback on production. It was a buyers' market for sure.

This time around, the impact of the cutback is clearly successful, and therefore sellers may find they have more leverage and certainly more guaranteed profits with Brent prices at $60/b.

However, Asia has not lost its significance amid the shakeup. For Asian buyers worried about rising prices, a third benchmark crude could offer some reprieve. Dubai crude, a grade against which several Middle Eastern and Russian crudes are priced, is looking more and more competitive against Brent by the day. The M1 Brent-Dubai Exchange of Futures for Swaps, or EFS, is a key spread watched by the market to evaluate the value of Dubai-linked crudes against Brent-linked crudes. Last year, the EFS was at its narrowest in 13 months at $1.79/b on November 28, 2016, according to S&P Global Platts data.

This year, it rose to its widest in 11 months at $2.60/b on October 30. The impact is that Dubai-linked crudes, such as those produced by the majority of Opec members, may see even more favor from Asian buyers as term negotiations proceed.

Now that the success of the Opec-led effort has borne fruit in term of pushing prices beyond $60/b, the questio that is on investors' minds is how much further will the producer bloc sustain these efforts. Is a $60/b global benchmark price level sufficient to undo the damage that producers have suffered from overproduction? Or is Saudi Ara[illegible] ambitious effort of even more aggressive cuts and price rallies?

The kingdom's Crown Prince Mohammed bin Salman recently spoke of h[illegible]s backing for an extension to Opec's crude output cut beyond its current March 2018 deadline to rebalance the global market.

"The kingdom affirms its readiness to extend the production cut agreement, which proved its feasibility by rebalancing supply and demand," the crown prince said in a statement October 30.

Mohammed bin Salman, the son of the reigning monarch King Salman al-Saud, is the key driver of the Opec kingpin's oil policy.

"The high demand for oil has absorbed the increase in shale oil production," he added.

"The journey towards restoring balance to markets, led by the kingdom, is proving successful despite the challenges," he said.

While he has backed an extension, the details of any deal, including its length, allocations or any other new terms, will have to be negotiated before the coalition's next meeting on November 30 in Vienna.

An agreement is far from certain. Russian energy minister Alexander Novak, who is due to meet Saudi oil minister Khalid al-Falih in Riyadh this week, said he does not see the need to announce any extension at the November 30 meeting.

As ever, geopolitical uncertainty in the region also remains a concern critical to the success of any extension of the deal. Examples of recent geopolitical concerns include Iraqi and Kurdish claims to oil territory in the wake of the recent Kurdish independence referendum, Iran facing an uncertain outlook with its crude exports as the US threatens to abandon the nuclear deal, and the Saudi-led embargo on Qatar that was straining relations among Gulf Cooperation Council member states.

Deal participants will likely wait until closer to the current agreement's March expiry before making a decision on an extension.

Of course, this means all eyes will be on the upcoming November 30 meeting in Vienna for signs of consensus among the countries, most important of which would be Saudi Arabia and Russia, two of the deal's biggest participants.

For the time being, ICE Brent crude futures remain near 27-month highs on the expectation that planned supply cuts will be extended to the end of 2018.

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