Could world cope with another major disruption to oil supply?

Only Saudis have spare oil capacity and it is very thin

LONDON: A battle for market share between oil producers has left the world awash with stocks of unwanted crude and driven a collapse in prices over the past two years. But a study of one often overlooked oil market parameter-spare capacity or the ability of producers to quickly ramp up output to cushion against unexpected supply cuts elsewhere- shows that a major bullish trend for prices could be building.

With Iran, Iraq, and Gulf nations Kuwait and the United Arab Emirates all producing at or almost at capacity, there is only a handful of states that have a significant gap between current production levels and what they can produce in theory. The word "theory" is key here, though, as those countries include Libya, Nigeria, Venezuela and Saudi Arabia.

The chances of an end to unrest in Libya and Nigeria or of Venezuela overcoming its social and economic problems and ramping up production are so low that most analysts are writing off theoretically higher capacity levels in those countries. That leaves Saudi Arabia, the only major traditional swing supplier, as the sole global central bank of spare capacity. But the assumption also comes with a caveat.

Having told the market for many years that they can produce 12.5 million barrels per day if needed, Saudis, including Deputy Crown Prince Mohammed Bin Salman, have said this year they can ramp up supply immediately only to 11.5 million bpd.

Deduct from that figure Riyadh's current record output of 10.7 million bpd, and that leaves Saudi and effectively global spare capacity at only 0.8 million bpd-the lowest on record and not enough to cover even one major supply outage. "Supply constraints seem a distant prospect in the current oil market, but a return to balance in 2017 will leave the world with severely limited spare capacity," HSBC's oil industry analysts said in a note.

Others broadly share that view. "In a market full of disruptions and uncertainties, if there was a blow up of the scale of Canada once again, we would see oil prices rise like we did pre-summer," said Abhishek Deshpande, an analyst at Natixis.

Wildfires in the Canadian region of Alberta in May cut the country's daily output by 1 million barrels and were one of the factors that pushed oil prices to a six-month high.

RECORD STOCKS

So is it inevitable that when global oil demand finally rises close to or above supply in the next few months, prices will jump on fears of a lack of spare capacity? Not necessarily.

For analyst Deshpande, countries like Nigeria still pose downside risks as their contribution to the market is unpredictable. "Assuming all countries were producing at their optimal levels, including Libya and Nigeria, and markets were balanced, it is then I would be really worried about thin spare capacity," he said.

Meanwhile Iraq, Kuwait, the UAE and Saudi Arabia are all set to add new capacity in 2017 as they are drilling on new fields. Separately, the world has accumulated so many stocks over the past two years-standing at a record 3 billion barrels according to the International Energy Agency-that they have become a substitute of sorts for spare capacity.

Before the supply glut started building in mid-2014, stocks stood at just 2.6 billion barrels. It would take many months to bring them back to that level if demand were finally to exceed supply next year.

However, some observers believe that the constraints on spare capacity mean a bigger cushion needs to be maintained. "There is no reason stocks should return to pre-collapse levels. The lack of swing suppliers calls for more," said veteran OPEC watcher Jamie Webster. — Reuters

Oil extends gains after big US crude stock draw

LONDON: Oil prices rose more than 1.5 percent yesterday after US industry data showed a large drawdown in crude stocks, reflecting the temporary impact of an Atlantic storm. US crude stocks fell by 12.1 million barrels last week, data from the American Petroleum Institute showed after the market settled on Wednesday, compared with expectations for an increase of about 200,000 barrels. Benchmark Brent crude oil was up 75 cents a barrel at $48.73 by 1025 GMT, after settling up 72 cents on Wednesday. US light crude was up 85 cents at $46.35, having ended the previous session up 67 cents.

Stocks of US crude have been at record highs in the past two years, thanks partly to an output-boosting shale oil boom. But Tropical Storm Hermine, which threatened the Gulf Coast refining region last week before moving to the East Coast of the United States, led to the loss of some US oil production. The US government said on Aug. 29 that 11.5 percent of Gulf of Mexico output was shut in as a precautionary measure.

"The big crude draw was a temporary move," said Tamas Varga, analyst at London brokerage PVM Oil Associates. "The big picture is bearish. The API stats are only a road bump on the way down." Oil was also buoyed by robust trade data from China, which showed its crude imports in August surged by nearly a quarter from a year ago to the second-highest amount ever, driven by independent refiners rushing to cash in on low oil prices before import quotas expire in December.

Oil hit a one-week high on Monday after Russia and Saudi Arabia agreed to cooperate on stabilising the oil market. Prices have since fallen because of uncertainty over the chances of an output freeze being agreed by producer nations, particularly after an April meeting in Doha failed to reach an agreement. — Reuters

MUMBAI: Chairman and Managing Director of the Mahindra and Mahindra Group, Anand Mahindra (left) shakes hands with CEO of Ola cabs, Bhavish Aggarwal during a joint press conference in Mumbai yesterday. Ride-hailing service Ola has formed an agreement with Mahindra and Mahindra to offer cars cheaply to drivers. The Indian automaker has agreed to sell and finance vehicles for 40,000 Ola drivers by 2018 and the deal is worth $400 million, both companies said at a press conference in Mumbai. — AFP

Adios Algiers, oil options hint output deal may lie further ahead

LONDON: The oil options market indicates traders are not betting big on OPEC and rival Russia clinching a meaningful deal this month to control output, although investors have turned more optimistic. The oil price is heading for its first weekly rise in nearly a month after Saudi Arabia and Russia said on Monday they would work closely to monitor fundamentals and to recommend measures to ensure market stability, including a potential production freeze.

OPEC member countries and Russia will meet on the sidelines of the International Energy Forum in Algiers later this month and have signalled a freeze could be on the agenda. The initial $2.50 gain in oil to a high of $49.40 a barrel after the Saudi-Russia news was short-lived, not least because of the failure of the two sides to reach any deal on output at a special meeting in Doha back in April.

But the derivatives market shows that investors could well be holding out for a deal further down the line and are displaying a lot more optimism, as demand and supply come closer to falling into balance. The options market has seen a near-across-the-board rise in the implied volatility, a measure of the price, in buy options relative to sell options this week.

"The overall situation in oil, in my view, is stabilising. The stock draw should be with us as we head into the fourth quarter," said asset manager RCMA's chairman Doug King, whose Merchant fund runs some $220 million in commodities.

"One would say that there is a distinct chance in the next six months that we do get into some of the inventory, which would act as a catalyst for investors to increase exposure to the oil market".

When supply is expected to outstrip demand in the longer term, buy, or "call" options tend to be cheaper than sell, or "put" options as investors generally bet on the greater likelihood of oil prices falling rather than rising.

Puts are still pricier than calls, but by far less than they were just a couple of weeks ago, particularly those that are said to be close-to-the-money, or likely to be profitable. The premium of a put maturing in one month, around the time of the Algiers meeting, is around 422 basis points more expensive than a call expiring at the same time, compared with 550 basis points a week ago.

DOHA REDUX?

A major sticking point at Doha was getting Iran to join any group initiative on production. Iran has said that while it supports joint efforts to stabilise the market, it will not freeze production until its own output reaches pre-sanctions levels of around 4 million barrels per day, from an estimated 3.6-3.8 million bpd now.

"The timeframe to reach any agreement to freeze is not necessarily in September. It will need to include Iran and that will be more likely to be at the end of the first quarter of next year," Petromatrix strategist Olivier Jakob said. For puts maturing in May next year, when a supply agreement might theoretically materialize, their premium over calls has fallen to 570 basis points from 600 basis points last week. Money managers, who in early August had built the largest short position in crude futures since the start of the year, have now cut those bets in half.

"Rebalancing is definitely taking place, to some degree or another. It's most definitely seen in the European market ... where inventories really have been coming down a great deal since the beginning of the year," said Christian Gerlach, who helps run around $350 million in commodity-related funds for Swiss & Global Asset Management, part of Julius Baer.

OPEC and Russia are pumping at, or close to, record rates, while US production has started to pick up after months of decline, making investors wary about the effectiveness of a freeze, especially given uncertainty over the global economy. Regardless of whether the market believes there could be any freeze, regular verbal intervention is paying off. From the first whispers of possible coordination in February, the price has risen by 51 percent and the premium of oil for delivery by December 2017 over that for December 2016 has slimmed down to $3.60, from closer to $5 a month ago.

The International Energy Agency believes the market will show no oversupply over the second half of 2016. "We have no real spare capacity in OPEC at all. It's 'full blast'," RCMA's King said. — Reuters