OPEC+ reaches a historic deal: but is it enough?

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Following an impasse that lasted from 6th March until Easter weekend, OPEC+[1] are finally ready to start cutting oil production again. The pain from falling demand and rising supply that led to Brent oil prices falling to an 18-year low was too much to bear for oil producing countries[2]. However, to get the producers together was difficult after the rift emerged between Saudi Arabia and Russia that led to what we described as the Greek Tragedy[3] on March 6th. That obstacle was overcome by President Trump (US) brokering a conversation between President Putin (Russia) and King Salman (Saudi Arabia). The US's role in the deal did not end there. After Mexico disagreed with its allotted cut of 400,000 thousand barrels per day, the US stepped in to implicitly agree to cut for Mexico. This clearly highlights that the US is as desperate as the members of the cartel to see oversupply curtailed and oil prices higher.

The Mexican standoff

The 'Mexican standoff' on Thursday 9th April led to large delays in the proceedings and by the time the G20 countries met on Friday 10th April, a deal was still not established. The G20 meeting, chaired by Saudi Arabia was an opportunity for consumer countries to express the extent of demand destruction they see and what they are doing to reduce supply (in countries that are large producers as well). However, the communique from this meeting was weak, with no firm numbers in terms of commitment. Apparently original drafts of the communique had much stronger wording, paraphrasing the European Central Banks's Draghi's "whatever it takes" language. However, the watered-down version available seems to be the product of a lack of agreement and distrust among members.

The OPEC+ deal as its stands is summarised as:

- Production cuts of 9.7mn barrels per day (mb/d) from May to June 2020 relative to October 2018 levels for most countries
- Reference point for Russia and Saudi Arabia is 11mb/d (which is higher than what they were producing in October 2018)
- Cuts taper to 7.7mb/d from July 2020 to December 2020 and then to 5.8mb/d Jan 2021 to April 2022
- Individual country quotas are not yet available on OPEC's website.

Is the deal sufficient?

That will be the largest ever coordinated cut in oil production. The key question is whether this will be enough to bring the oil market back in balance?

With demand destruction forecasts ranging from 15-22mb/d[4] in April 2020 and these measures not even coming into place until May, we are likely to see a substantial overhang in the short-term. But the deal does last until 2022, so production restraint could mop up excess supply at the back end. Clearly nobody really knows the length and amplitude of the of the COVID 19 related demand destruction, but at least the second part of the twin shock on oil markets (the supply boost) is being addressed.

Extreme contango to stay

In the short-term we think that oil market extreme contango[5] will persist. Although there is no reliable data on global storage capacity, the fact that tanker rates have risen by 116%[6] in March 2020 indicates that land storage is running low and hence floating storage is in high demand. Also, the price of West Texan Intermediate at Cushing is at a US$6 premium to West Texan Intermediate in Magellan East Houston (31 March 2020), indicating that oil stored in-land is trading at a significant premium to that on the coast. Given that the deal doesn't come into force until May and Saudi Arabia is selling oil to Asia at the deepest discount seen in decades, we think near-term oversupply and price weakness will keep the front end of the oil futures curve at a heavy discount to the back end of the curve.

[1] Organization of Petroleum Exporting Countries (OPEC) is a cartel of 13 oil producers. OPEC+ is the cartel and 10 partner countries.

[2] See An age of unprecedented oil volatility.

[3] See Post OPEC meeting note - OPEC's Greek Tragedy.

[4] Bloomberg Survey 31 March 2020.

[5] See An age of unprecedented oil volatility. Contango is a situation where the futures price of a commodity is higher than the spot price. Contango usually occurs when an asset price is expected to rise over time. This results in an upward sloping forward curve.

[6] Source: data from Bloomberg based on Very Large Crude Carrier (VLCC) and ultimate source is SSY.

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