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FUTURES INSIGHTS

Middle East OSPs – Getting the Balance Right

How OSPs have gained greater prominence and helped to balance the market

AUGUST 2020 CONTRACT

OSP	TOTAL EXCHANGE VOLUME	TOTAL DELIVERY	ADV
$41.58	98,635 CONTRACTS	12.790 MILLION BARRELS	4,483 CONTRACTS

Official Selling Prices (OSPs) issued by Middle East crude producers have been keenly watched by oil traders for many years, with OSPs acting a key indicator for spot trading and as a broad indication for OPEC policy.

But in recent months OSPs have attracted a far wider audience with observers across the energy spectrum - including physical and financial traders - looking for any hint as to market direction.

The unprecedented demand slump caused by Covid-19 pandemic and record cuts from the OPEC+ group and allies, led by Saudi Arabia and Russia, has heralded a new era where every policy signal from key producers can impact oil prices.

OPEC's primary goal in production targets is to keep the market in balance, both globally and regionally, and OSPs are used in array of tools to support the market-balancing policy.

However, in the current environment traders and analysts will look for any kind of guidance towards policy or pricing direction.

OSPs and the trading cycle

The following section refers to OSPs for Asia-destination crudes, the key outlet for Middle East crude, and where Oman crude acts as a key benchmark.

Historically Saudi Aramco has an assumed role of regional/OPEC leader and announced its OSP differentials ahead of other Middle East producers.

Typically, this will be in the first week of the new month, setting a differential to the underlying benchmark for the following month.

For example, Aramco will inform customers of differentials versus underlying benchmarks for August-loading crude in early July.

The underlying benchmark plus or minus the differential is the price customers will pay for crude in August.

However, the underlying benchmark will reflect the 'trading month', and given that Middle East crude trades on a 'Month-2 basis' the underlying price in August will reflect October-loading barrels; or M+2.

Precise methodology in determining differentials is a closely-guarded secret, but due to the two-month spread between the loading and trading months the market structure plays an important part in OSP setting.

Additionally, overall supply/demand fundamentals, refining margins and customer feedback are also believed to play a part in fine-tuning OSPs.

Once Saudi Aramco's has published its OSPs, other National Oil Companies (NOCs) will follow, typically adjusting prices roughly in line with Aramco for similar grades.

For instance, Abu Dhabi will most likely move the Murban OSP in line with Aramco's Arab Extra Light, or Iraq's SOMO will adjust its key Basra Light grade along with Arab Medium.

The over-the-counter (OTC) spot market generally picks up during the second half of the month, once traders have had a chance to digest the OSPs.

Benchmarks and the spot market

The majority of Middle East crude is sold to customers as part of annual term contracts, which gives security of supply/demand to both buyer and sellers, plus allows producers a greater say in the final destination of its crude and prevent regional imbalances.

But there is also a sizeable minority of Middle East crude that is freely traded in the spot market, allowing for transparent price discovery mechanisms and produce underlying benchmarks.

Oman is the only freely and fully tradeable grade in the Middle East, which is why it was selected as the underlying grade for the benchmark DME Oman futures contract in 2006.

Oman is also the most actively traded grade in the OTC spot market, which along with the DME futures contract makes Oman crude the single most important Middle East grade in terms of price discovery.

Additionally, Oman is also a deliverable grade into Shanghai's INE crude contract, broadening its range as a key Asian benchmark price.

Dubai is also used as a benchmark in Middle East crude pricing for Asia and assessed by a number of leading Price Reporting Agencies (PRAs) including Platts, Argus and ICIS.

However, the Platts Dubai assessment is typically used in preference to Argus or ICIS.

Dubai crude oil production is too small to support a stand-alone benchmark so allows delivery of some other grades, including Oman.

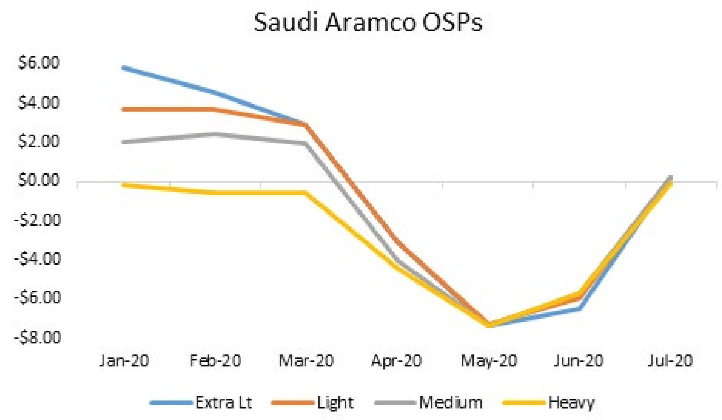
Again, this adds to Oman crude role as the principal benchmark grade for Asia.

A paper published June 2020 by The Oxford Institute for Energy Studies displayed the following chart on underlying OSP benchmarks.

Entity	Formula to Asia	Type	Issue Date vs Loading
SOMO	Platts Dubai + Platts Oman	Forward	One month before
NIOC	Platts Dubai + Platts Oman	Forward	One month before
KPC	Platts Dubai + DME Oman	Forward	One month before
QP	Platts Dubai + Platts Oman	Forward	One month before
ADNOC	Platts Dubai	Forward	One month before
DPA	DME Oman	Forward	Two months before
ARAMCO	Platts Dubai + DME Oman	Forward	One month before
MOG	DME Oman	Forward	Two months before

Full report available

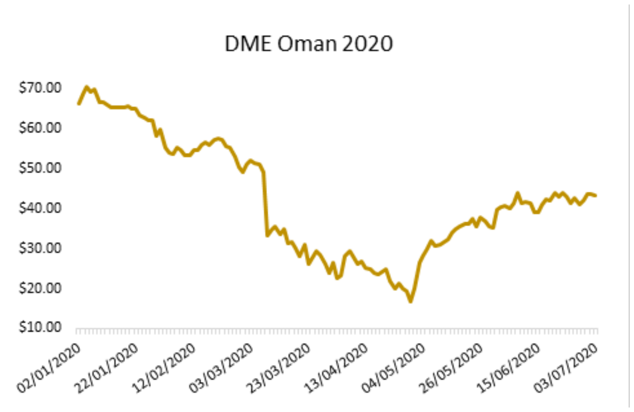
OSPs respond to market swings



OSPs started the new year relatively strong but as the coronavirus pandemic swept the globe and demand collapsed by up to 30%, Middle East producers took drastic action by cutting OSPs to record lows – which in turn coincided with the steepest-ever contango in the market.

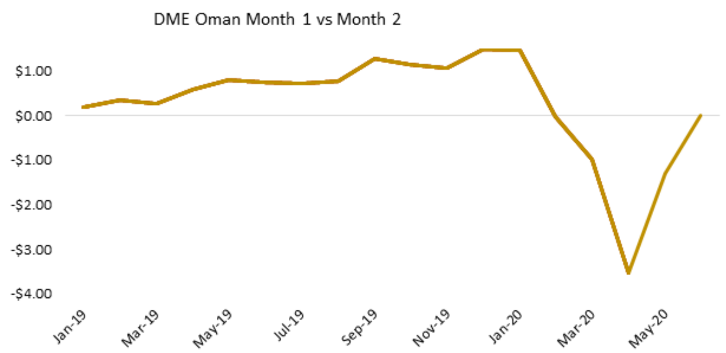
This also corresponded with non-OPEC producers unable to agree on a Saudi-led proposal in March to reduce global production by up to 20 million barrels per day. As a result, Middle East OSPs were thrust to the forefront of the global trading cycles during the unprecedented demand collapse in the first-half of 2020.

Q2 volatility, record spreads and recovery



The M1/M2 DME Oman spread fell to an all-time low of more than minus $5/b and averaged around minus $3.50/b during April.

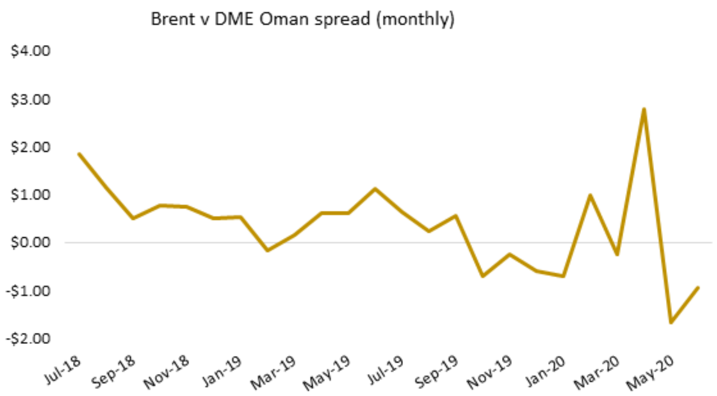
But by managing the supply/demand balance through production cuts and OSPs, the market has been brought back into equilibrium.



In June the front-month Oman spread averaged zero and in early the July the September/October spread was trading in a narrow backwardation structure of around +$0.15/b – suggesting the market is neither long nor short.

Brent/Oman also saw major volatility as demand initially contracted Asia, but then rebounded as the European recovery lagged behind Asia.

At one point Oman was around $6/b under Brent, while at the peak of Asian demand destruction Dubai was almost $10/b under Brent. However, by June, both Oman and Dubai were trading a premium to Brent.



Summary

2020 will go down as one of the most dramatic years in modern world history and analyzed, reviewed and discussed in the oil markets for years to come.

So as we move into the second half of 2020, the question is did OPEC and other global oil producers get the balance right?

With prices stabilizing around the $40/b mark, forward structures flattening out and no sign of either panic buying or selling, the answer has to be an overwhelming yes.

That said, there's still half of 2020 to go.

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