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Saudi oil attacks

This past weekend has seen significant attacks on Saudi Aramco facilities, which has led to the disruption of 5.7MMbbls/d of oil production. For now it is still uncertain how long this disruption will last, but what is clear, is that the longer this outage lasts the more bullish it will be for prices

Source: Shutterstock

What happened?

Early Saturday saw the use of drones to attack crude oil processing plants in Saudi Arabia, with the 7MMbbls/d Abqaiq plant hit, whilst the 1.45MMbbls/d Khurais oilfield was also hit. The Saudi energy ministry has said as a result of the attacks, 5.7MMbbls/d of crude oil output has been affected, along with 2bcf/d of natural gas production.

The Iranian-backed Houthis in Yemen have claimed responsibility for the attack, and follows the attacks we saw on Saudi oil infrastructure earlier this summer. However, this time around it has been significantly more disruptive, with 58% of Saudi oil output affected. Fortunately, reports suggest that there were no casualties with this latest incident.

What now for the oil market?

Clearly these latest developments are bullish for the oil market. In recent months, market participants have failed to price in a risk premium around Middle East tensions, despite a number of incidents over the summer. Instead, the market has been focused on trade developments and the broader macro environment. However now with almost 20% of OPEC production taken offline over the weekend, this is likely to change. How bullish will really depend on how long the outage lasts. There have been reports that production could return to normal in a matter of days, which if the case means the upside would reflect more of a risk premium, rather than a significant tightening in the market. However, we believe any indication or confirmation from the Saudis of a prolonged outage, would see Brent trading back above US$70/bbl in the near term.

It is not just the flat price that is poised to move higher, nearby time spreads are also likely to move deeper into backwardation, reflecting the tightening in the prompt physical market. OPEC+ production cuts in recent months have already been supportive for spreads, and this latest development will likely only give them a further boost higher.

However looking beyond the supply lost from this incident, the attack does highlight the vulnerability of the Saudi oil infrastructure. Whilst many have been worried about disruptions to oil flows through the Strait of Hormuz, this latest incident does suggest that such attacks can prove even more disruptive. Furthermore, is the uncertainty of how the Saudis will respond to the attack, but what is certain is that the market needs to price in a risk premium for the simmering tension in the region.

Finally, the exit of John Bolton as the National Security Advisor to President Trump suggested that we could see the US relax its stance with Iran when it comes to sanctions. However, this latest incident means that it is an unlikely scenario now. Following the attack, US Secretary of State Mike Pompeo was not shy to put the blame on Iran.

Can the market manage with this lost supply?

The Saudis have said that they will use inventories to meet exports. If we see a disruption of only several days, then the market should be able to absorb these losses fairly easily. However, if outages start to run into weeks, this would leave the market increasingly tight. Looking at the Joint Organisations Data Initiative data, Saudi crude oil inventories have been in steady decline since 2015, and this is no surprise with ongoing production cuts. At the end of June, crude oil inventories stood at almost 188MMbbls - down from around 205MMbbls at the end of 2018. This is equivalent to around 26 days of crude oil exports. Current levels are likely to be even lower, with the continued deep production cuts that we see from Saudi Arabia.

The US Department of Energy has also said that it would act if needed, by turning to its strategic petroleum reserves, which stand at 645MMbbls. The International Energy Agency also said that is was following current developments closely, but for now believes that there are adequate commercial stocks to absorb production losses.

Finally, a prolonged outage could mean that OPEC+ relaxes production cuts. However whilst this may help, it would not be enough to make up for the full Saudi shortfall. There are only a handful of OPEC+ members that can bring a meaningful amount of output onto the market. Between Russia, UAE, Kuwait and Iraq, we could see them bring in the region of 800-900Mbbls/d of production online, which is significantly less than the outage in Saudi. The issue for the market is that more than 70% of OPEC spare capacity sits in Saudi Arabia.

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