The Telegraph

Oil speculators risk 'short squeeze' if impulsive Saudi Prince throws Opec surprise

Saudi Arabia risks a 'horrible family feud breaking out into the open' at a make-or-break Opec summit on Friday

Prince Mohammed bin Salman, the 30-year-old master of Saudi Arabia Photo: Getty Images

By Ambrose Evans-Pritchard

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123 Comments

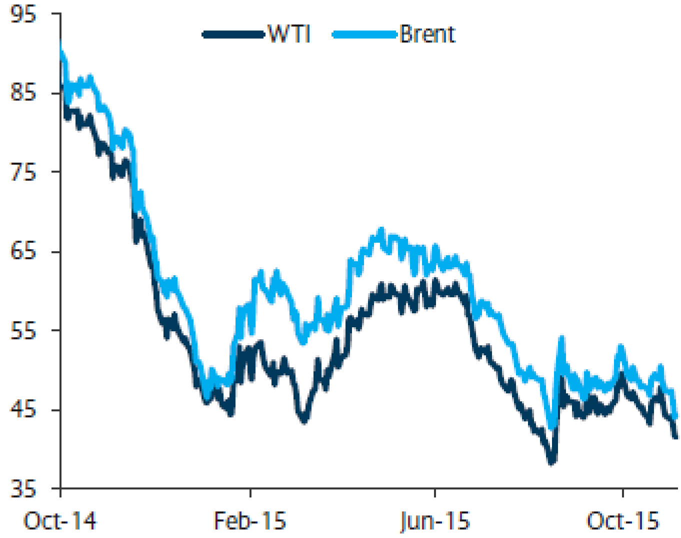
Hedge funds have taken their bets. The market is convinced that Saudi Arabia will ignore the revolt within Opec at a potentially explosive meeting on Friday, continuing to flood the global markets with excess oil.

Short positions on US crude and Brent have reached 294m barrels, the sort of clustering effect that can go wildly wrong if events throw a sudden surprise. **The world is undoubtedly awash with oil** and the last storage sites are filling relentlessly, but speculators need to be careful.

They are at the mercy of opaque palace politics in Riyadh that few understand. Helima Croft, a former analyst for the US Central Intelligence Agency and now at RBC Capital Markets, says the only man who now matters is the deputy crown prince, **Mohammed bin Salman**.

FIGURE 5

Front-month WTI and Brent ($/bbl)



Source: Bloomberg, Barclays Research

The headstrong 30-year-old has amassed all the power as minister of defence, chairman of Aramco and head of the Kingdom's top economic council, much to the annoyance of the old guard. "He is running everything and it comes down to whether he thinks Saudi Arabia can take the pain for another year," she said.

The pretence that all is well in the Kingdom is wearing thin. Austerity is becoming too visible. A leaked order from King Salman - marked "highly urgent" - freezes new hiring and halts public procurement, even down to cars and furniture.

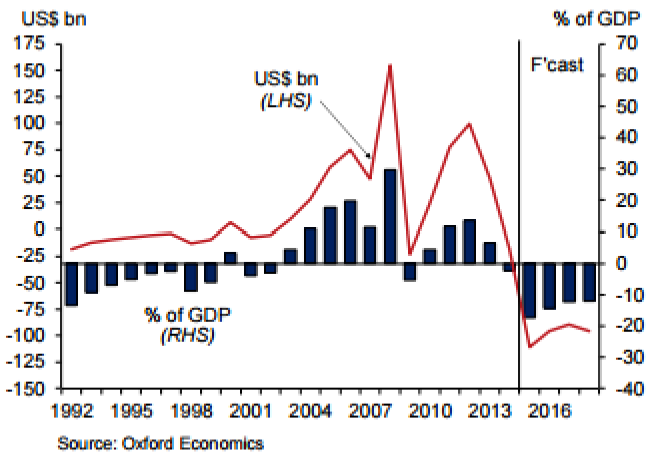
"Mohammed bin Salman is running everything and it comes down to whether he thinks Saudi Arabia can take the pain for another year"
Helima Croft, RBC Capital Markets

The system of cradle-to-grave welfare that keeps a lid on public protest and holds the Wahhabi state together risks unravelling. Subsidies are draining away. It will no longer cost 10p a litre to fill a petrol tank. VAT is coming. There will be a land tax. Yet these measures hardly make a dent on a budget deficit running near $140bn a year, or 20pc of GDP.

The German intelligence agency **BND issued an extraordinary report warning that Prince Mohammed is taking Saudi Arabia into perilous waters**. "The thus far cautious diplomatic stance of the elder leaders in the royal family is being replaced by an impulsive interventionist policy," it said.

The war in Yemen - Saudi Arabia's "Vietnam" - grinds on at a cost of $1.5bn month. It is far from clear whether the Kingdom can continue to bankroll Egypt as Isil operations spread from the Sinai to Cairo suburbs.

Saudi Arabia: Government budget balance



The risk of a Saudi sovereign default over the next 10 years has suddenly jumped to 23pc, measured by credit default swaps. Riyadh's three-month Sibor rate watched as a gauge of credit stress has spiked to the highest levels since the Lehman crisis.

Nerves are so frayed in Riyadh that the interior ministry is lashing out blindly. There are reports that more than 50 prisoners are to be beheaded, including **Sheikh Nimr al-Nimr, the Shia cleric sentenced to death for leading civic protests in 2012**
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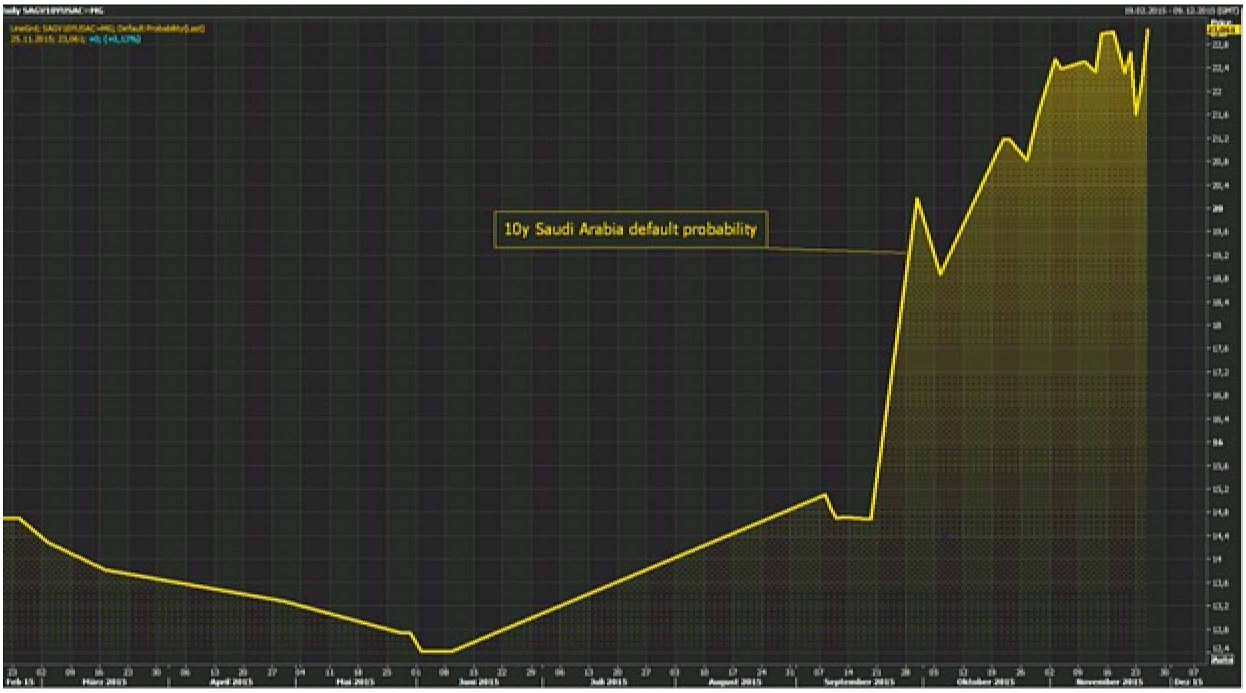
A protester holds up a picture of Sheikh Nimr al-Nimr during a rally at the coastal town of Qatif Photo: Reuters

There is no surer way to light the fuse on wholesale conflagration in the Shia stronghold of the Eastern Province, where the oil reserves lie. Shia underground groups in Iraq have threatened a whirlwind of gruesome revenge if the execution is carried out.

This, then, is the state of Saudi Arabia a year into an **oil crash that the Kingdom itself engineered to drive out rival producers**.



The question for Prince Mohammed is whether it is worth pushing his oil strategy to the limit, even to the point of rupturing Opec. "They want to prevent a horrible family feud breaking out into the open, but what will they do if countries threaten to revoke their Opec membership?" asked Dr Croft.

Venezuela's president, **Nicolas Maduro, says his country will lay out plans for a 5pc cut in Opec production**, trimming global supply by 1.5m barrels a day (b/d).

For months he has been in despair, protesting bitterly as the Gulf strategy cuts off half his funding and drives the Chavista revolution into its final agonies. Yet all of a sudden he is strangely cheerful.

Iranian president Hassan Rouhani, left, shaking hands with Venezuela's president Nicolas Maduro in Tehran in November

"There are going to be nice surprises in the next few days for the recovery of the market," he said after visits to Riyadh and Tehran, and after receiving the Emir of Qatar in Caracas. Perhaps he has been told something. Clearly the hedge funds are betting that it is just wishful thinking.

The veteran Saudi oil minister, Ali al-Naimi, says that nothing is pre-ordained before the meeting. "We will listen and then decide," he said.

He is certain to get an earful. Iran's oil minister, Bijan Zanganeh, wants cuts of 1.7m b/d and a return to the agreed ceiling of 30m, targeting a price band near $70. "It is clear which countries have produced more than their quota," he said.

Saudi Arabia derives more than 80pc of its total revenues from the sale of oil Photo: Alamy

Algeria, Angola, Libya, Nigeria and Ecuador all back variants of this position. Iraq is more complicated but it is all but bankrupt and is cutting vital funding for anti-Isil militias. "They have lost 42pc of their revenues and can't even pay the salaries of civil servants and the security forces," said Dr Croft.

"The risk of a systemic sovereign failure is clearly rising. Four of our ‘fragile- five’ Opec countries (Iraq, Libya, Nigeria and Algeria) are front-line states in the war against Isil and these countries will be hard passed to continue funding their security services and government apparatuses in a sub-$50 environment. While Libya and Iraq are already atop of our Opec risk scale, we would caution against concluding that things cannot get even worse," she said.

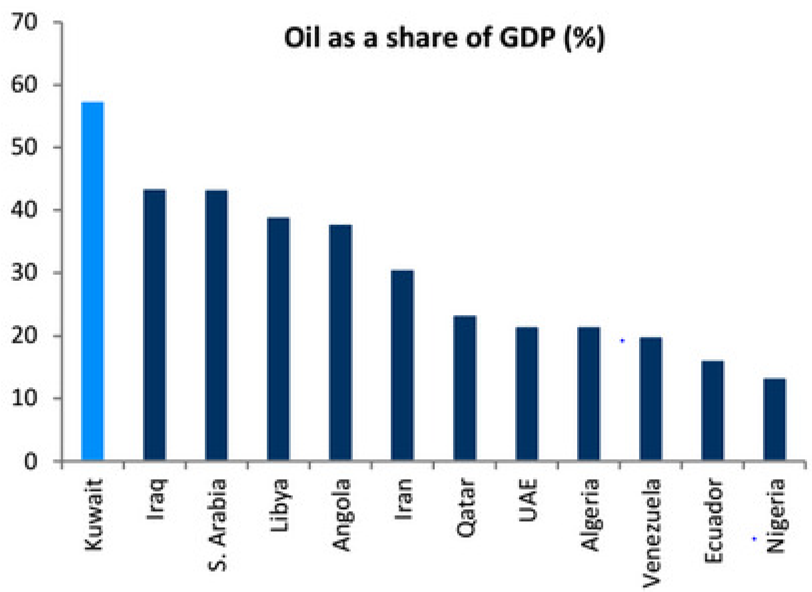
"What will they [Saudi Arabia] do if countries threaten to revoke their Opec membership?"
Helima Croft, RBC Capital Markets

The Saudis are not going to back down or admit that their policy is engulfing everybody in an unwinnable quagmire, but they might catch the speculators off guard with a form of "forward guidance". They might try to set off a nasty "short squeeze" by talking up prices, perhaps by agreeing to a Blue Ribbon review of a $70 price band.

The Saudi royal family itself is divided. Prince Abdulaziz bin Salman, the deputy oil minister and an elder son of the King, raised eyebrows in Doha last month by warning that the low oil-price strategy is dangerously misguided. It is leading to massive cuts in investment, setting the stage for a future spike in prices.

Some $200bn of projects have already been cancelled, mostly in ultra-deep waters, the Arctic and the Canadian tar sands. A new report by IHS says investment from 2015 to 2019 will be $1.5 trillion less than it would have been, and spare capacity is down to a wafer-thin 2m b/d.

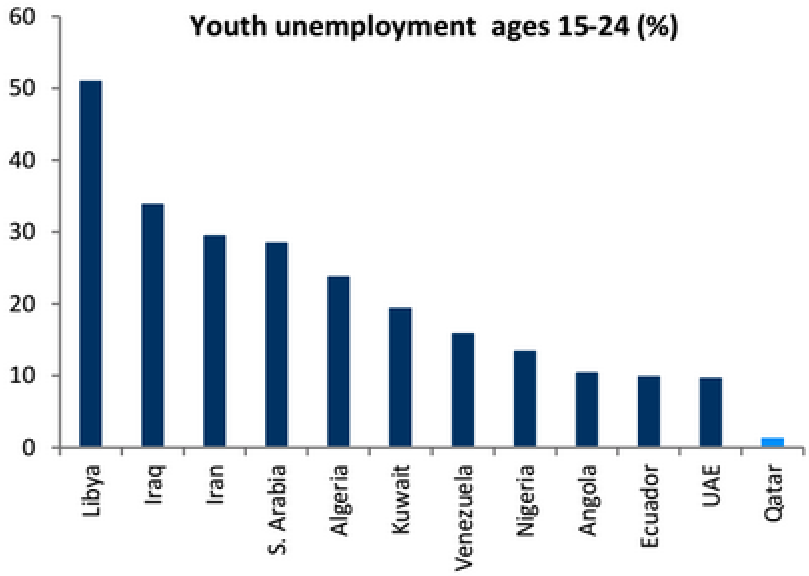
This is the stuff of nightmares. All it would take is a political upset anywhere in the petroleum world to send prices through the roof. If the Saudis want to retreat on Friday, this line of argument gives them an honourable way out.



As Prince Abdulaziz hints, the Saudis must tread with care since their own long-term future will be even more at risk if a fresh shock calls into question the reliability of oil as an energy source, and sets off another great push for solar power, electric cars and rival forms of energy - this time crossing the final and irreversible threshold that ends the age of oil.

The scorecard for the Saudis and their Gulf allies a full year after flooding the market cannot be what they hoped for. The promised recovery keeps receding. Brent crude is still languishing at $43, down from $114 in mid-2014.

The International Energy Agency says Opec's annual revenues have dropped by $550bn. "If you have 1m barrels a day extra, you just destroy the market. We’ve created it ourselves,” Oman's oil minister said last month.



They have clearly failed to curb output by Russia, the world's number one producer again and pumping near record volumes. The Kremlin has scorned repeated offers of alliance with Opec, though we cannot be sure: any such arrangement would have to be deniable - by wink and nod - given that Russia's oil private companies are supposedly answerable to shareholders.

"Saudi Arabia may face a critical choice: cut oil supply, or de-peg"
Francisco Blanch, Bank of America

The collapse in the rouble from 32 to 65 against the dollar may have been a cold douche for Russians but the currency has served its role perfectly as a shock-absorber, shielding the Kremlin budget from the loss of oil and gas revenues.

Saudi Arabia is discovering that its riyal peg is fraught with problems. Francisco Blanch, from Bank of America, says the currency peg is forcing the country to burn through reserves at a pace that could soon reach $18bn a month.

The 12-month riyal forward contracts – watched by experts for signs that traders are betting on a collapse of the peg – has soared to 650 from 13 points in June. "Saudi Arabia may face a critical choice: cut oil supply, or de-peg," Mr Blanch said.


Riyadh

The politics of a riyal devaluation would be ugly. Mr Blanch's conclusion is that the path of least resistance is to nurse oil prices back to more tolerable levels instead.

Russia is in deep economic trouble but ultimately it can always fall back on its industrial and scientific base, and it can feed itself. The Saudis are abandoning their last surviving wheat fields for lack of water. This is not a duel they can win.

Yes, the Saudi strategy has finally begun to inflict damage on the US shale industry. IHS expects total US ouput to fall to 8.7m b/d by April 2016, a drop of 900,000 b/d from a 43-year peak in April of this year.

Yet it has taken longer than expected and the geostrategic cost has been higher. It is a Pyrrhic victory in any case. Fracking costs have fallen so far that the industry will probably spring back to life as soon as crude reaches $55.

High-debt companies will fall like flies over coming months when their hedge contracts expire but their technology cannot be wished away. Bigger players with stronger balance sheets will take over.

There is a loose parallel with the dotcom boom and bust. Hundreds of the highflyers in the late 1990s went bankrupt: the information revolution scarcely missed a beat.

Shale frackers will be snapping at the heels of Opec for years to come. There is nothing the Saudis can realistically do about it.