The Telegraph

Saudis are going for the kill but the oil market is turning anyway

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Russia is a key undeclared target of Saudi Arabia's oil price war

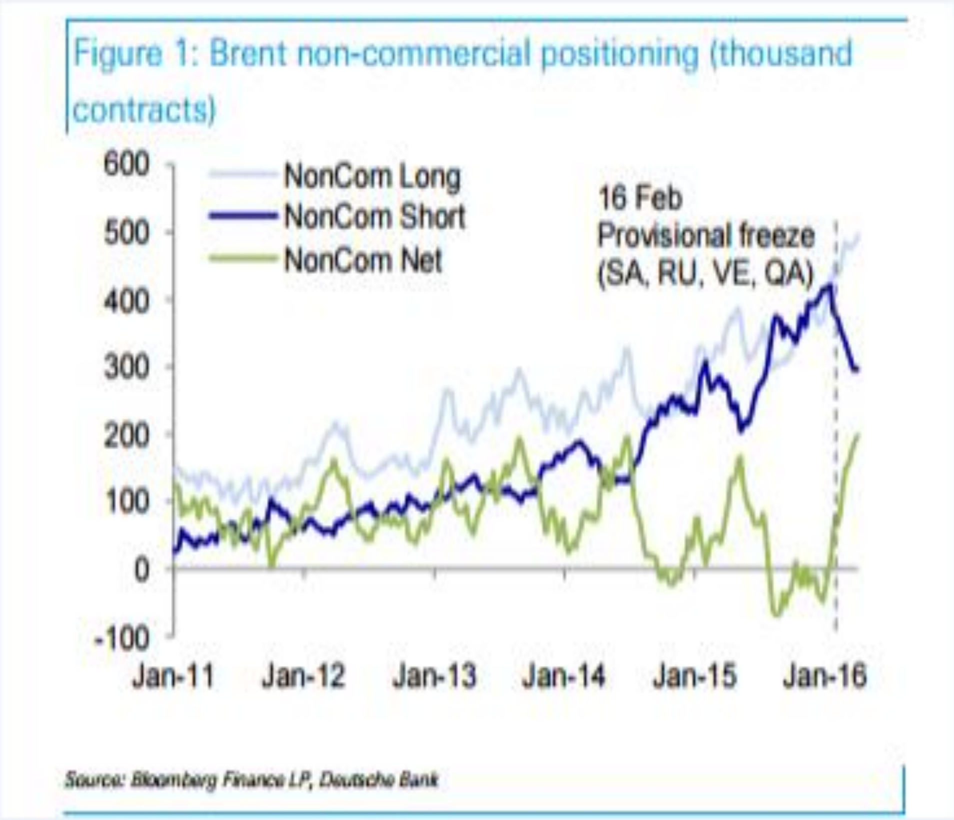
The collapse of OPEC talks with Russia over the weekend makes absolutely no difference to the balance of supply and demand in the global oil markets. The putative freeze in crude output was political eyewash.

Hardly any country in the OPEC cartel is capable of producing more oil. Several are failed states, or sliding into political crises.

Russia is milking a final burst of production before the depleting pre-Soviet wells of Western Siberia go into slow run-off. Sanctions have stymied its efforts to develop new fields or kick-start shale fracking in the Bazhenov basin.

Saudi Arabia’s hard-nosed decision to break ranks with its Gulf allies at the meeting in Doha - and with every other OPEC country - punctures any remaining illusion that there is still a regulating structure in global oil industry. It told us that the cartel no longer exists in any meaningful sense. Beyond that it was irrelevant.

Hedge funds were clearly caught off guard by the outcome since net ‘long’ positions on the futures markets were trading at a record high going into the meeting. Brent crude plunged 7pc to $41 a barrel in early Asian trading, but what is more revealing is how quickly prices recovered.



Speculative net long positions are extreme. Hedge funds are betting on an oil rally
CREDIT: DEUTSCHE BANK

Market dynamics are changing fast. Output is slipping all over the place: in China, Latin America, Kazakhstan, Algeria, the North Sea. The US shale industry has rolled over, though it has taken far longer than the Saudis expected when they first flooded the market in November 2014. The US Energy Department expects total US output to drop to 8.6m barrels per day (b/d) this year from 9.4m last year.

China is filling up the new sites of its strategic petroleum reserves at a record pace. Its oil imports have jumped to 8m b/d this year from 6.7m in 2015, soaking up a large part of the global glut. Some is rotating back out again as diesel: most is being consumed in China.

Goldman Sachs says the twin effect of rising demand and supply disruptions across the world is bringing the market back into balance, leading to a “sustainable deficit” as soon as the third quarter. The inflexion point could come sooner than almost anybody expects if a strike this week in Kuwait drags on as oil workers fight pay cuts. The outage is already costing 1.6m b/d.

Kuwait’s woes are the first taste of how difficult it will be for the petro-sheikhdoms to impose austerity measures or threaten the cradle-to-grave social contracts that keep a lid on dissent across the Gulf.

There is little doubt that Mohammad bin Salman, the deputy-crown prince and de facto ruler of Saudi Arabia, wanted an excuse to sabotage the Doha deal. He added a fresh demand that non-OPEC Norway should also limit output – a non-starter - as well as hardening the Saudi objection to Iran’s full return to pre-sanctions output.

The calculus is that his country has the deepest pockets and will ultimately stand to gain by shaking out weaker players. This is a gamble. Saudi Arabia is running through $10bn of foreign exchange reserves a month to plug its fiscal deficit. The fixed riyal peg makes it much harder to roll with the budgetary punches as Russia is able to do with the floating rouble.

Saudi Arabia is not as rich as often supposed. Per capita income is the same as in Greece. Standard & Poor’s has cut its credit rating twice to A-, and for good reason. The Saudis never built up a proper sovereign wealth fund in good times. Their reserve coverage is two-thirds less than in Kuwait, or Abu Dhabi.

Saudi Arabia is not as wealthy as it used to be CREDIT: GETTY

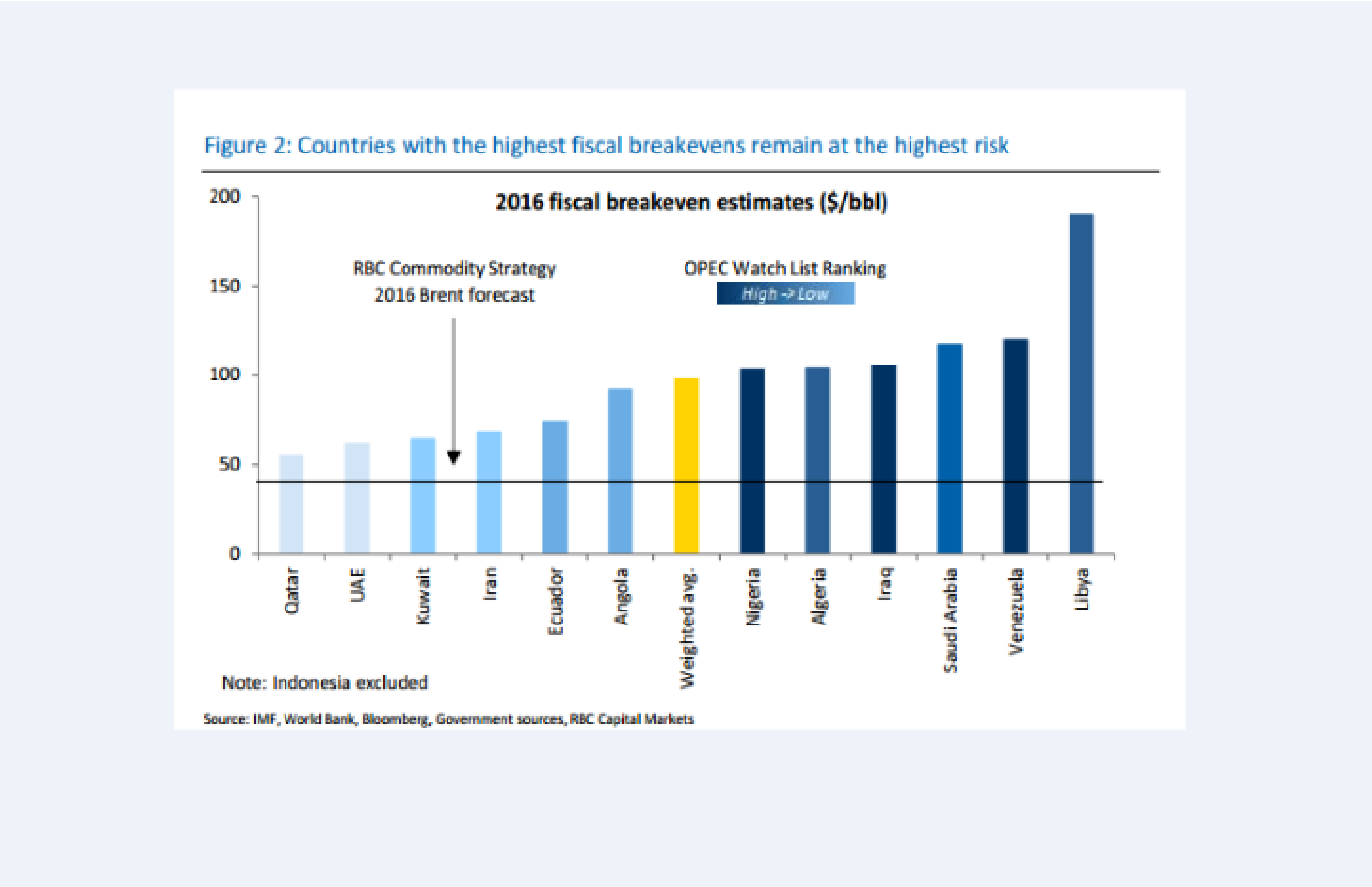
The Saudi price war has several targets. A top official hinted at the hierarchy a month ago, listing Iran, Russia, the Arctic, Canada's oil sands, Venezuela's Orinoco tar, ultra-deep water wells, US shale, and renewables, in that order.

The primary foe is obviously Iran, the leader of Shia Islam and arch-rival for strategic dominance of the Middle East. The two countries are at daggers drawn in Syria, Yemen, and Iraq.

Many suspect that the secondary undeclared foe is Russia, currently the world's top producer at 10.8m b/d but short of money and running down its infrastructure. The Kremlin will exhaust its budget reserve funds by the end of the year, forcing Vladimir Putin to contemplate draconian budget cuts. The Saudis may think it worth going for the kill by trying to hold down prices for a few more months.

The trouble for the Saudis is that their strategy has probably killed OPEC – the instrument that leverages their global power – and may set fire to their own strategic neighbourhood, if it has not done so already.

Helima Croft from RBC Capital Markets has raised the bank's stress gauge for "geopolitical risk" on six OPEC countries, warning that several are on a precipice. "Many were struggling with political and security challenges when oil was above $100 and they are now being forced to seek emergency lending," she said.



Most OPEC states are deeply underwater at current oil prices CREDIT: RBC CAPITAL

Venezuela has already collapsed. It is on a four-day working week. Inflation is 700pc. Nicolas Maduro's regime is running out of money to pay oil workers. It risks a repeat of the strikes in 2002/03 that cut oil production by 80pc. Without Chinese funding it faces a "humanitarian catastrophe" this year, she said.

Angola has slashed spending by 15pc of GDP and even so it has been forced to go cap-in-hand to the International Monetary Fund after vowing that it would never do so.

Nigeria has lost 390,000 b/d in output due to a wave of assaults by militants since the Buhari regime ran out of protection money to pay them off. These included a sophisticated underwater attack on a Shell pipeline at the Forcados terminal.

Iraq is supposed to be the great hope of global oil supply over next decade but is in no better shape. The collapse in revenues has set off a vicious circle, with delayed payments to contractors leading to an investment strike. It too is in the arms of the IMF.

Iraq was supposed to be the great hope for new oil production CREDIT: REUTERS

ISIS terrorists set fire to oil wells in the Khabbaz field near Kirkuk last week. Suicide bombers struck in Basra early this month, and terrorist actions are moving ominously close to the Iraqi crown jewel, the Rumaila oil installations. Security officials say ISIS is targeting the oil heartland, yet the government is so desperate for funds that it cannot pay vitally-need Shia militia groups.

In Libya, ISIS has gained a foothold in the heart of the oil region around Sirte. It has vowed to ignite rebellion in Algeria, another state spiraling into financial crisis. Most of the Maghreb is now a powder keg.

Any one of these countries could spin out of control. It is not far-fetched to imagine two or three occurring at the same time. This would change the dynamics of the oil markets in a heartbeat and would bring the ageing post-Lehman expansion of the global economy to an abrupt halt, exposing the nasty pathologies that have been building up.

It never was cheap oil that threatened our economies. The scare earlier this year was misguided. It is the next oil supply crunch we should fear most.