Rory Johnston: Discretionary Risks To The Oil Market

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Erik: Joining me now is Commodity Context founder Rory Johnston. Rory, it's great to catch you back on the show. You know, when I saw you on the schedule, I thought I just talked to Rory a couple of weeks ago. It's been months since we've had you on now. Everything's changed, though I guess you and I had a completely incorrect understanding of where this whole OPEC thing was going, because it's just been announced by none other than President Trump's campaign, that what's going on here is OPEC is working as hard as they possibly can to suppress oil prices, because they want to get Kamala Harris elected. I know this is exactly what you've been commenting on in the data that you follow so closely. Maybe not. What's going on here? Is this just politics? And more importantly, what is the real situation with respect to OPEC's intentions here? What is their real intention?

Rory: Yeah, so that's exactly right. And I think you and I exchanged briefly on Twitter about this. So the statement from former President Trump was essentially along the lines what you said, going all out to depress oil prices in order to help elect Democrats and specifically Kamala Harris, because the belief being that Kamala Harris would be somehow better for OPEC. I assume the reference here is to Kamala's 2019 statement that she would ban US fracking, which I don't think will ever happen. But again, I mean, it's useful, it's an election year, truth is kind of, and reality is secondary. But I think it's important, and I thank former President Trump for this hook. Because I'm writing a piece right now on really kind of disentangling the true extent of how much OPEC is actually supporting the market. It's important to note that while, we'll get to a second about, the current weakness in the market and what we're seeing, but most forecasters, whether it's the EIA, IEA, OPEC, or a whole bunch of different private sector forecasters, all generally expect that as OPEC extended its production cuts into the third quarter of 2024, that we're going to see a net deficit continued strength, at least in a fundamental basis in the oil market from that. But relative to what Trump was saying about going all out to produce and depress the price of oil, OPEC is doing the exact opposite. It's going all out to support the price of oil, excluding the COVID era cuts because I think those are a special case, but excluding COVID. The current amount of supply that OPEC is withholding from the market roughly 4 million barrels a day of realized tangible cuts relative to October 2022 levels when this new cutting cycle restarted again. That's the most crude that OPEC and OPEC+ is withholding from the market since the 2008/2009 financial crisis. These are crisis level production cuts and market supports. At a time when last year, demand grew by more than 2 million barrels a day. In any other year, this would be considered a strong year for oil markets. The only difference is that OPEC is supporting us multiple, you know $10, $20, $30, $40 higher than we were if OPEC was to completely release, but open the floodgates and release all the crude to the market, we

would probably be sub $50 Brent. That's a lot of oil that's being withheld from the market. And I think, while I do not think that OPEC will release that all at once, I think obviously, OPEC, more than anyone else, wants high oil prices. The longer they hold these cuts back the longer they maintain this crisis level support for the market, the weaker discipline and kind of cohesion across OPEC+ becomes, and I think that is just a time series. You know, the longer you go on holding these cuts, the higher the probability that the whole agreement breaks down and the ultimate bearish scenario of all this crude coming back to the market comes all at once.

But if we're just looking at a base case, and that's not my base case, I should be very, very clear. We're looking at a base case, OPEC has said that it's going to start easing the latest tranche, about 2.2 million barrels of oil to 22 million barrels a day of production cuts back into the market beginning in October and extending a year forward into 2025. But if you look at most of the forecasts from the major agencies, IEA, EIA and OPEC itself, most of those agencies really don't seem to indicate that there's going to be enough room in the market to eat all those production cuts back without tanking the price. Now, Saudi oil minister Abdulaziz bin Salman has said that that plan is market dependent and I believe him on this. I think that it's unlikely that OPEC is going to go ahead with a full production cut easing, I think at best, they're going to do half and probably even less than that. But I think we're going to need to wait to see where we are, come October, to see when and how exactly they stickhandle the messaging around pushing that back. Because I think it's even more important than the message, the market is seeing the message to the membership because the reason that they had announced that cut easing was that they were trying to placate members, particularly the United Arab Emirates, which has been promised continually that they're going to be allowed to produce more just one day, just around the corner and so far, we haven't seen that

Erik: Rory, this is a time in history where escalating geopolitical tensions are really the focus of, I think, the most important attention of macro analysts and so forth. Let's take this from another angle. If we get the politics of what was said out of it, and come at it from the opposite angle of, we're looking at things like, you know, the whole world is dependent on the Taiwanese semiconductors. Therefore, if China invades Taiwan, it could shut down the global economy. There's a big risk there. Let's talk about what the real risks are. It seems to me that what you're really saying is, OPEC has an incredibly large amount of power to foment outcomes, economic outcomes in the West, if they want to, they could do that to advance their own business interests. It's even conceivable if a real conflict were to develop, that they could use some of their economic power as a tool of negotiation, or as even a tool of retaliation. What is the power, if you were to describe the various power sources on earth? How much power does OPEC have? And how much influence do they have over the global economy as a result of the fact that they're holding this decision? 4 million barrels, as you say, that until recently, that was pretty much the entire spare capacity of the world. Now, it's just the discretionary amount that OPEC happens to be holding back right now. It seems to me they've got a huge amount of power. And if anything, our politicians should be explaining how much power we've put into the hands of some people that, frankly, our foreign policy is maybe starting to alienate.

Rory: The challenge, particularly forecast in this market, is that not only does OPEC hold, I would say the dominant power and the oil market right now. And I think it's not an overstatement to say that OPEC gets to choose whether or not prices this year or next are at around $80 a barrel or around $50 a barrel. And right now, its decision calculus is that it needs that money. And I wrote a piece a little while ago called OPEC's Price, and this idea that OPEC has historically, not explicitly, had a price target. And they were actually very wary of that idea for the same reasons that the Fed doesn't explicitly state whatever, let's say S&P target it's looking at or whatever else, that would show its hand and allow front running. But what you can see is that OPEC, through its actions, it has revealed preferences, that that target price has jumped considerably higher since before COVID. Before COVID, OPEC would really move to support the market if prices are below $60, $50 a barrel. Now, when the latest round of cuts began, and in late 2022, the price of Brent was sitting around $90 a barrel. This is a much, much higher price level. And overwhelmingly the reason that I think that this is the case is that OPEC members broadly, but specifically, and most importantly, Saudi Arabia has had much larger spending commitments, and kind of budget requirements for oil prices, you know that that's their main source of revenue. So they can't really afford these prices going much lower. But the challenge is, is that the reason that OPEC doesn't have unlimited power is that there are other things that OPEC is competing against, most notably, non-OPEC sources of supply, the United States, and in this case, also Canada, Brazil, Guyana, and a smattering of others that are growing production, because of these higher prices. So, Saudis are holding prices at $90 a barrel that's really attractive and profitable for a whole host of non-OPEC producers.

So, when they had initially held those prices higher, the belief was that you wouldn't have such strong growth from US shale, because everyone knows, quote, unquote, that shale has peaked. I've heard this for a decade, and we haven't seen it yet. And I think, to a degree, policymakers in Riyadh were believing that. But the challenge is, is that because of this, this is discretionary, because policymakers are deciding when to know, when to like toggle a switch on or off, it's not as easily forecastable. You have to kind of approach it from a scenario perspective. Either they do support prices, or they don't support prices, and to what degree. But what you're seeing is that, so far, they have continued to support prices. Now, again, that the challenge here is that that requires political capital within OPEC in order to maintain that discipline. And that, I think, is what generally erode over time. But really, it comes down to that decision and what price they're going to defend. And, so far, they've continued to hold $80, I think that they won't let the price collapse outright. But until we see what that realized price is going to be, I completely agree that that Western governments are in this bind, where OPEC is trying to hold these prices higher. You have other discretionary levers in the global oil market, most notably things like the US SPR, and the Chinese SPR, but interestingly, and again, going kind of against what former President Trump had said in that tweet, or truth or whatever we want to call it, is that the US SPR has been in buying mode, the Chinese SPR is now going back into buying mode. So virtually every discretionary lever in the global oil market right now is actually trying to support prices higher, not the other way around. The question is, how much does the kind of structural, real fundamental demand picture support higher prices going forward. And on that side, we're seeing increasing signs of weakness creeping in all over the place, most notably in China, where last year, Chinese demand grew by nearly 2 million barrels a day year over year. That's a

staggeringly strong demand growth, by my count, larger than any single country's demand growth in the history of the oil market.

But now, as of April and May, where we have full data, it looks like Chinese demand is actually not just flatlining, but actually an outright contraction versus last year, whether or not that can stabilize and turn back up is going to go a huge way towards who is going to be right about the outlook for global demand. This year, there's been this long, ongoing debate about whether or not the IEA and the EIA, which are expecting around a million barrels a day of growth, demand growth this year, or OPEC, which extracts two and a quarter million barrels a day of demand growth, a huge difference between them who's going to be right. And right now, it's looking increasingly like, it's more likely to be that 1 million barrels a day of growth and potentially even lower. So, we're going to see over this next month when the new round of forecasts and these agencies come out, how much they lower those forecasts, because I think that's kind of the big question. Global demand, of course, is going to set that final true benchmark and the kind of guardrails around what type of market OPEC is able to ease back into, because really, while you have non-OPEC supply competition, the primary thing that's going to determine the space OPEC has to ease those cuts is going to be global demand. And right now, that's not especially supportive.

Erik: Rory, I am in strong agreement with everything you're saying. Except, I see a gigantic elephant in the room, or in the case, of the oil market. Maybe it's a camel in the room? I'm not sure. But something doesn't add up here for me, which is, look, everything you're saying is, there's going to be 4 million barrels OPEC could take that off the market if they wanted to. There's growing pressure for them to do exactly that, President Trump is promising that he's going to persuade them to do that. If OPEC were to just dump that 4 million barrels a day on the market, as you say, we could easily be headed to sub $50 Brent. Furthermore, if you look at other markets, look at Dr. Copper, really down hard below the 200 day moving averages. We're recording on Tuesday morning, S&P 500 took a really hard hit on Tuesday morning as well. Boy, really looks like we're headed lower, maybe we're headed to $40 oil prices, Rory. And you and I understand this, because we've been doing it long enough that we both know, the thing that we should look for is in the term structure, we should expect a shift into contango. Wait a minute, we're seeing the exact opposite. We've got really steep backwardation, which is the oil market’s most reliable signal in my opinion, that says the exact opposite of everything we've been saying. The forward curve is telling us, with this steep backwardation that there is an extreme physical shortage that could take prices much higher very soon. How do we reconcile this?

Rory: Rewind even two, three weeks ago, and I would completely agree that the crude curve was exceptionally backwardated. I think that that dovetails really nicely with those expected Q3 deficits that everyone expected we're going to see. But I was just noting, even this morning, you've seen that that backwardation steadily start to erode. And I think you've actually seen a big sell-off in term structure today. So today, we saw crude, we're recording this on Tuesday, July 30, we saw a big sell-off today in crude again, crude now, you know, Brent bases sub $79 a barrel, we're getting closer to the lows we saw in early June following the post OPEC meeting

route. And unlike that period, where you actually had some kind of stronger signals, backwardation was, I think, a bit more robust. The physical market signals were a bit more robust despite that flat price fall off. Now we're actually starting to see the opposite, you know, versus two weeks ago, just before the Brent contract rolls over. So in periods like this, I'd like to shift to this spread between the second and third futures months and backwardation on that basis has fallen from nearly $1 a barrel two weeks ago to more like 50 cents a barrel today. So it is still decently backwardated, no doubt. And I think that physically, the market probably still is in some degree of deficit. But that tightness is rapidly easing. If we can lose half the backwardation in two weeks, who's to know where we're going to be in two, three weeks from now. I think that if that true bearish demand scenario that we were just talking about, does kind of continue to linger and persist over into August, I think that yeah, I think that we could see oil markets flipped back into contango. And if that happens, you're not only going to see kind of, obviously, the broader kind of expectations of the market shift. But because of the way that speculators hold their positions on the crude curve, because they want to benefit from that roll yield, you're also going to get additional speculative selling, which is going to push momentum even lower. So, I think that's this kind of really bearish downward spiral that we could see in oil here, if that comes along. Now, I think, like you were saying, the truest indicator in the market is term structure. And that is strong, but much weaker than it was even two weeks ago. If the physical expectations, the SD, or the supply demand balance in the market does prove to be correct, I expect us to come back into backwardation again, but that's going to be the ultimate tell. And I think, again, if we see in two weeks, these markets continue to sell off and those updates from IEA, EIA and OPEC, start to show weaker Q3 pressure, I think that that very easily could kind of add to this kind of rolling negative momentum we see in the market. But again, I don't expect that as my base case. But that's currently where the market is, is definitely pointing from a risk management perspective.

Erik: I want to apologize to any listeners who are not familiar with these concepts for going a little deeper on this. But I think it's really important, because I think this signal is so important. Everything you said, I agree with completely and I was thinking exactly the same thing, which is, it seems like what we're seeing is a collapse in backwardation that would suggest that maybe we are beginning that road toward a structural contango in the crude market. But hold on, I've been studying term structure in crude pretty darn closely for a long time. And when that, what we both just said starts to happen, what you almost always see is that the front month is where the backwardation comes out of the market at first. So, you go from a situation where the first two or three months on the curve have the most backwardation to those are the ones that go into contango first, or they just level off, or they come to a lesser backwardation than the later months out on the curve. We're not seeing any of that, the front month is still the widest backwardation on the curve that doesn't match the pattern we just talked about.

Rory: So far, and I think, again, two, three weeks ago, that was even more true that when you've seen this crude sell-off for the past two weeks, it has been disproportionately felt along the front of the curve. Right now, and anyone that follows the Brent market, and again, apologies for going kind of deeper and wonky here, is because of the way that the Brent market settles, that prompt contract spread or that prompt calendar spread is especially unreliable as a

signal, it gets very spiky right around expiry, which is why shift to that second or third month spread, which is in my humble opinion, a kind of more stable, slower moving, and I think less prone to false signals. But I definitely agree. And I would say that even if you look at it, it trends very closely with the prompts in all, but those expiry periods. And on that basis, again, it's weakening. So I think, while still backwardated, if we didn't have any other data in the market, I would say, yes, we are still in a supply deficit market. But that supply deficit is weakening. And you know, as everyone always says, the market looks ahead. So if, let's say demand is based on my data, and again, I'm going back to the other fundamental data now, supply growth is maintaining relatively firm, whereas demand growth is weakening very quickly. So, if we continue that trend forward, it's very easy to see how we end up into an oversupplied market, which would then justify contango conditions. Now, again, we're going to need to see where we come over the next couple of weeks here. I think it's going to be a very important couple weeks, because I think most notably, this question of, is China going to remain in effective contraction? In 2022, when really more than anything else, the two big things that derail the oil market rally in 2022, were one, we didn't see the supply collapse in Russian production that everyone was expecting. And two, I think even a larger physical loss of the market was, Beijing embarked along its extremely draconian, COVID zero production cuts during that period. That was the first annual contraction we've seen in Chinese oil demand in decades. I think it's more like 30 years, depending on the data you’re using. Right now, if Chinese demand stays roughly around May/June levels through the rest of the year, because of how strong Chinese demand was in the second half of last year, that base effect is such a huge hurdle to clear. If we stay flat right now for Chinese demand, we will effectively be in another year of very modest but still contraction. That is a very, very not great signal. I think what's really interesting here is, because we can look at Chinese demand for a couple different reasons, obviously, I look at it primarily for the oil kind of implications, you know, where the supply and demand are going, but a lot of other people kind of look at it in terms of a macro signal, what's happening with China's industrial economy, et cetera, et cetera. And when you look at that, there's a lot of concern that the primary area of weakness in China right now is in diesel, which is the part of the barrel that's most closely connected to the industrial economy.

But I think here, there's actually a really interesting nuance to point out. And while everyone has been talking about how we should be expecting any day now, global gasoline demand to really start to feel the brunt and the kind of contractionary pressure of rising EV sales, particularly in China, gasoline and jet fuel are the consumer driven fuels, are actually the only real bright spots in Chinese oil demand right now. So it's not EVs that's driving that. But what we are seeing on the diesel side is increasing stories and increasing evidence of actual LNG or natural gas displacement in long haul trucking, which is fascinating because even a couple years ago, we wouldn't have expected LNG to be that much cheaper. But because of the route and the kind of weakness in global LNG pricing as well, you've seen this really strong cost competitive drive for Chinese long haul truckers to shift their fleets into this LNG or compressed natural gas drive train system. And, it's really hard to get really granular estimates of this in China, because it's very opaque. But it's somewhere between 300,000 to 600,000 barrels a day of demand destruction, or demand displacement, from that specifically. And what's fascinating is, we actually see the similar, in many ways, in the United States, not from LNG displacement, but

from renewable diesel displacement. So diesel is this market that I, myself have said for years, would be one of the longer term, more robust areas of the oil market, because even though gasoline demand was going to start getting eroded by EV sales, you weren't going to see the same pressures in diesel because you can't electrify long haul trucking in the same way, the economics and the physics just don't work that way. But when we're seeing direct one for one displacement with renewable diesel estates, and LNG and trucking in China, will all of a sudden that argument starts to break down. And I'm starting to get very worried around diesel as an actual engine of growth going forward. We're going to see how far this can go. And I think there are a lot of very reasonable criticisms of the economics of renewable diesel in the United States, and whether or not it can really stand up on its own. But China is not subsidizing LNG in the same way that the United States is subsidizing renewable diesel. And that's continuing to drive that out. So, I think that even beyond the broader macro weakness in the Chinese economy, you're also having idiosyncratic weakness in the diesel structure in China, driven by this displacement.

Erik: Rory, I want to go back to what you said about shale and whether it's peaked. Because a lot of smart people have persuaded me that, look, if you're considering where this market is headed and the OPEC cuts and all that stuff, you don't really need to worry about that in the long term. In the short term, it's very important. But in the long term, this is really clear, what's happening is, shale has much steeper decline profiles than conventional oil, that we've pretty much tapped out shale, it's almost done, it's almost over, the shale revolution is pretty much peaked out, it's almost done. And as soon as that goes into decline, look out baby, because that's when the global energy crisis that cannot be solved begins. Boy, that sounds really persuasive. Except that what keeps happening is, the US shale industry keeps on kicking ass and keeps on breaking every record, they do seem to be hitting a plateau here, at least in the weekly data. But you've said before, the weekly data is not the best place to analyze that. So what do we make of this, a lot of smart people are really convinced that shale can't have much longer before it not only peaks, but it goes into a unnecessarily irreversible decline that cannot be prevented. Hasn't happened yet.

Rory: Basically, I've been actively working in this market for about 12 years. And I've heard that shale has peaked in almost every one of those years. So, at the very least, US shale production, and broadly, kind of US title production has exceeded expectations every year I've been working in this market. At this stage. I think, if you have given forecast for US production, I think your handicap should always just be, it's probably going to be slightly higher and everything obviously, but COVID, and that was obviously because prices went negative and that's obviously going to have a pinch effect. Well, you saw, I mean, everyone's pointing right now and I think reasonably, I mean, it makes sense to be wary about continued or particularly accelerating growth from US shale, when you see a peak and a pullback in the US oil directed rig count. This is obviously the number of rigs in the field, drilling new wells that you need to keep that going because, as you noted, shale is a treadmill. It's a very steep treadmill, so you need to keep that going. It gets harder and harder to keep up. But, if we looked at the US rig count alone, and said that will be the fate for the US oil production trajectory this year than last year, you actually saw rig counts peak at the end of, around 2022 and fell through most of 2023.

So, that year, we absolutely saw US shale decline, right? Actually, not only did it not decline, but it doubled the initial expectations of growth. The EIA initially was expecting somewhere in the ballpark of 600,000, 700,000 barrels a day of US total liquids production, ended up being closer to 1.5 million barrels a day. That's a lot. That's a lot of production. And I think, again, when you look at, when I would go back to OPEC for a second, I think OPEC was banking on the United States, not just having that 700,000 barrels a day growth, but probably underperforming, because they were very hopeful. But when they so thoroughly over performed or outperformed that expectation, and then you also have the add on about 700,000 barrels a day of additional Iranian supply, well, all of a sudden, they lost all of their expected room to ease these production cuts.

If you remember, when Saudi Arabia initially agreed to its so called 1 million barrels a day lollipop cut in the summer of 2023, that was initially supposed to be a very temporary production cut. So temporary, in fact, that they were going to announce its fate on a month by month basis. Now, it just got rolled over and rolled over and rolled over because expectations of US supply decline or plateau, just never materialized. What you saw was that the use of increased efficiency across a whole bunch of metrics, those rigs were drilling, you had fewer of them, but they were drilling more productive wells, and they were drilling them faster. So, you're getting a lot more bang for your buck. That's still going to happen now. And I think the rig count always needs to be adjusted by whatever other productivity metric you are. So, people are going to get really angry at me and say, oh, well, sure they're drilling longer wells. So your per unit, your production per foot is declining. But I don't personally care that much about production per foot. Because, if you're drilling longer wells, it really kind of swamps it out what I care about, particularly when everyone's looking at the rig count is what your effective, kind of per well, productivity is and that generally has maintained and kind of supported higher production. I don't think, I mean, I should say everyone expects and then this is the IEA, OPEC, EIA, all expect the US shale production to slow this year relative to last year, notably, and continue to just slow into next year. But I think that is going to be largely dependent on prices. If prices are higher than I think, then growth will reaccelerate, because the US shale producers are the shortest cycle, most price sensitive supply source in this market. And they're going to follow the prices higher. Because, I think the other thing is here, in some ways, a collapse in OPEC production, cohesion and the kind of collapse in the deal, and a 4 million barrels a day of oil back on the market, that's very bearish, obviously. But what it would also do, it's also really bearish for US shale production because US shale producers are not going to likely break even at $50 a barrel Brent.

So if you want US producers to retrench, you're going to need lower prices, because they're still making money at this stage. You know, they're making less money now than they were at $90 or $100 Brent, but they're still making enough money to grow. So, I think the challenge for OPEC, and this is why it always, even a monopolist or a cartel in this case, needs to be conscious of other sources of productive competition and what it's doing to demand. So, if you get lower prices, one, that's going to help demand growth, particularly in emerging markets. And two, it's going to help pull back US shale supply. The other sources of non-OPEC production growth, Canada, Guyana and Brazil are generally going to be longer cycle and less price sensitive, at least in the short term than US shale is. But if you pulled back it, let's say, if that

bearish scenario happened, 4 million barrels a day of OPEC crude back in the market prices sunked up $45 a barrel Brent, I would expect those prices that we would see, not just a plateau but a contraction in US shale production. But I don't think it's likely going to happen, at least in the immediate term, with prices at $89 Brent.

Erik: As you eluded, Rory, the other big player besides the US shale is obviously Saudi Arabia. And I'm going to make the argument that with everything going on in the world, Saudi Arabia is both a very important geopolitical player right now, because they're seeking to stabilize and prevent a runaway situation with geopolitics in the Middle East. And they're also a very important and powerful player in the oil market as they've always been. Now, most lay-people who don't work in the oil market, you think Saudi Arabia, you think MBS Mohammed bin Salman, the Crown Prince and head of state of Saudi Arabia, I would argue and I'm pretty sure you're going to agree with me that for the purposes of the oil market, the person who is even more important to pay attention to is the one you mentioned earlier, Prince Abdulaziz bin Salman, callsign ABS that's MBS's older brother, he replaced Khalid al-Falih as the oil minister. Now, I've had a very strong impression ever since he took that position. First of all, when he took over, I got a very, very strong impression. This is an extremely confident man with a plan who knows exactly where he's headed in this new role. And frankly, that didn't add up. Because what was going on in the market at the time was all kinds of crazy things. And it just I didn't understand why he seemed so confident. But as I've watched this evolve over the last couple of years Rory, what I keep getting the sense of and I can't really pinpoint or put my finger on why I think this, but I think that ABS has a different job than his predecessor, Khalid al-Falih, I get the impression that Khalid al-Falih's job was the obvious one, we are in the oil business, we need to have representation on OPEC, it's the most important job in the whole country, we're giving it to you Khalid al-Falih, do a good job. I don't think that's ABS's job. I think that his job is to be the oil guy, as part of a much larger plan to transition the kingdom's wealth management strategy to diversify out of the oil business, try to get into as many other oil businesses and invest in other places around the world. And although on paper, it looks like supposedly ABS is just the oil guy and all he does is focus on the oil market, I have a very strong feeling that he is one of the key decision makers in a much bigger process and that there's a bigger plan for Saudi Arabia that they're not telling us. Am I crazy to think those things? Do you have any of those impressions? And what do you think ABS is up to and why he seems to be so confident and so certain of the direction he's taking this?

Rory: I think you're dead on. So, a couple things about ABS, and we'll just say MBS and ABS to just really make this speedier, ABS is also interestingly the first royal to hold the position of energy minister. Historically, it has been someone that has been much more of a civilian technocrat, more associated with Aramco, where you have had far more independence for Aramco and oil policy in Saudi Arabia outside of the direct control, or at least the day to day control of the royal court. And I think what you've seen in this case is that absolutely, I think that what, as I understand it, what it appears to be is that MBS has a lot of huge spending priorities through vision 2030. It's all being funneled through the public investment fund or the PIF Saudi, though one of the main Saudi sovereign wealth funds, they're spending huge amounts of money, Bloomberg had a really interesting analysis that recently that factored in PIF spending

and kind of calculated the so called fiscal breakeven price for oil for Saudi Arabia is something like $105, or it's above $100 a barrel. That's really, really high. And obviously, they need these prices higher in order to kind of maintain the spending and to not have to issue a bunch of debt. They're also doing things like selling off additional pieces of Aramco to the public market. But I definitely think that ABS's marching orders have been to keep prices higher.

So, I actually did in grad school, one of the major research papers was on Saudi oil policy, the equivalent of a thesis at the time. And what you look at is that the history of Saudi oil policy is very technocratic, and very generally, like small c conservative, it was very consensus based. You had a lot of very slow moving pieces, there wasn't a lot of volatility in the policy, the price stuff within OPEC, they wanted relative to all the members like Iraq and Libya that want higher prices and revenue right now to kind of fund their various budget issues. He said he had a much longer term perspective on this market. They wanted lower prices to help support the global economy to help, or at least not to help accelerate the development of alternatives like electric vehicles, etc., etc. So they wanted to be in the long game. What's interesting is, when MBS initially came on to the stage and there was all this talk. It's hard to remember almost a decade ago when you know that everyone kind of viewed MBS as this broad liberal kind of revolutionary, and in many ways, within the Saudi establishment. Obviously, that's changed considerably years on, but I think in many ways, one, he is still liberalizing a bunch of Saudi society. And two, the worry at the time was that, well, if he wanted to move Saudi Arabia past oil, then well, why wouldn't he just open the taps? Because the view is Saudi Arabia has these massively large oil fields and no one knows exactly how much is left in them. But I think likely, a lot of oil, particularly, potentially more oil that can ever be produced relative to global climate ambitions and everything else. Well, the view was, well, why not produce everything right now? Monetize those reserves, and then use that money to invest in things like real estate and tourism and high tech and everything else? That was the initial concern. There was a worry that MBS made really bearish for the oil market, because he wanted to basically push everyone out and maintain their position for as long as possible. What you've seen in reality seems to have almost been the opposite, that they have huge spending priorities. But now they're cutting. I mean, Saudi Arabia itself was withholding around 2 million barrels a day of crude from the market, that's on top of, likely in what they claim to be another million barrels a day of spare capacity on top of that, so the delta between what they are currently producing and what they say they can produce is actually 3 million barrels a day. Now, I usually forget that last million, because everyone gets very conspiratorial about it, and what they can really produce, etc. I don't think it's a hugely productive conversation. But we know that they were producing 11 million barrels a day at the end of 2022 and now they're producing 9 million. So there's a huge amount of, that's a huge amount of very valuable production. That's like $50 billion, $60 billion, almost of equivalent annual revenue at current prices. That's a lot of oil.

So the challenge for them is, the further they cut, the harder it is, because every time they cut production, that also increases the fiscal breakeven price, because it's not just prices that matter, its prices neck, it's prices times volume. So the more they cut, the more of the higher price that they need, which is why they don't think that they can justify cutting much more for much longer in order to kind of prop those prices even higher. So the question is, how can they

maintain this? And I think the big risk here is, if you see, let's say, another massive upside surprise, let's say US shale production, again, shockingly, surprises to the upside in the second half of the year, all of a sudden, then maybe MBS, and ABS start thinking, well, maybe we can't hold prices as high because it's just essentially subsidizing non-OPEC supply. And that's where the real worry begins. Now, again, I think the challenge here for the Saudis is they need these high prices right now. But I do think that the larger kind of going forward concern, as you were noting about diversification, et cetera, is why are they going to withhold production and hold prices high, if they really want to monetize those reserves? I think that is still this kind of big lingering question in the market of what they're going to do. And, at this stage, maybe they don't believe that global climate ambitions will be anywhere near achieved, and maybe they can maintain these prices for higher for longer, et cetera, et cetera. But the longer this goes on, and the longer they're fighting against this very challenging tide of both slowing demand growth and stronger non-OPEC supply, the harder that is to justify.

Erik: Rory, I think we're in agreement, ABS, I'm convinced is in charge of a whole lot more than just the oil market. And frankly, I don't think the kingdom wants the rest of the world to understand how much he's in charge of, or what the real plan is. I think it's a secret. In any case, time will tell on that one. I want to hit Russia next. Look, what's going on right now is a whole lot of very significant escalation. We don't know where it's headed. But I think we do have to talk about that other big hot potato in the room, which is what if we got to escalation where we've got tactical nuclear exchanges, and we really are moving in to direct military conflict between the West and Russia. Russia is still behind the US and Saudi Arabia of the one of the biggest producers in the world, we just talked about how the 4 million barrels that OPEC is holding back could have a profound effect on the market. If Russia got taken offline, that's 8 million barrels. So what would the impact be of an outright war with Russia on the oil market?

Rory: It would obviously be huge. And I think this is, you know, the oil market right now, and as we've kind of discussed through various points here, it's really hard to have just a steady, really high on a high conviction base case, because all of these big tail risks are very, there's no real black swans, there's just a ton of white swans kind of floating around that we know could come to the market at a particular point. But it's hard to put them in any particular base case. So yes, back in early 2022, a big part of the reason that prices spiked to $130, almost $140 a barrel Brent, was that there was, you know, the IEA I think it was in the April 2022, oil market report said that there was the risk, and they expected that that Russia was going to lose 3 million barrels a day of production. That's a lot of oil. You know, that alone is almost the equivalent of what I'm talking about, that OPEC is currently withholding from the market right now in total, that would have been at the time hugely bullish for prices, and I think possibly would have pushed us not to $250, but maybe even to $200 a barrel if it was realized.

Now, I think the challenge is, is that there's two things I think we need to consider here. One, we've already diversified a lot of the Russian flow away from the west. So it's going to China now, it's going to India, it's going to Türkiye, a lot of these areas that are absorbing Russian crude are not necessarily going to be as sensitive in a heightened geopolitical conflict. The other challenge here is, I would say, very frankly, it's impossible to know what, call it a broader

accentuation of this conflict if we actually had an exchange of tactical nuclear weapons. It's hard to think that the broader global economy wouldn't suffer, which would then take demand down with it. Now, but if you lost, let's say just, hyperbolically, that combination of Ukraine and Washington decided to really try and neuter Russia and obviously Ukraine has been going after Russian refineries. Let's say they go through a bunch of pipelines and they bring Russian production down by 50% or more, then yeah, that's good, then we could be tested, we could easily be testing very, very, very high prices again. Now, I think part of that is that now we actually have a huge amount, unlike in 2022, when again, one of the big bullish talking points at the time was that OPEC itself was struggling to keep up with its planned production increases, as you're easing back from those COVID era cuts. So there was a big question of like, does OPEC have any spare capacity left? Oh, my goodness, now we're going to lose 3 million barrels a day of Russian crude, that's how you could easily have gotten above $200 a barrel. Now, if you lost, let's say, 3 million barrels a day? Well, the rest of OPEC, at least that first tranche of losses could probably accommodate four. But more than that, I mean, I think that it's hard for me because people think 3 million barrels a day, okay, 3% of the market. That's not a huge amount. But in the most exceptional periods in bullish and bearish periods in the market, you're not talking about 3 million barrels a day Delta, you're talking about a million barrels a day of difference in either direction for a prolonged period of time. It doesn't take a lot at the margin to push this market into a bull cycle or a bear cycle, with the exception of obviously COVID, where you had like 9 million barrels a day of supply surplus in early 2020. But I think, so yeah, absolutely, a true loss of Russian production would be hugely bullish. I think the big question, though, is one, how much would demand suffer in that scenario? As well, I think that's the biggest challenge to really know firmly.

Erik: Longtime listeners already know my final question because it wouldn't be a Rory Johnston interview without a discussion of the Good, the Bad and the SPR, the Strategic Petroleum Reserve of the United States. I could ask you two dozen questions on the SPR, Rory, because you've done so much good work on it. In the interest of time, I'm going to leave it to you to just pull together what do we need to know about the SPR? What's the update?

Rory: Yeah, so essentially, what we've seen in the latest news, which was at the US DOE completed its most recent purchase of crude for the US SPR, of roughly 4.6, 5 million barrels of US produced sour crude, that's what they've been buying for the SPR. That brings the total to date to around 43 and a quarter million barrels to date. And I should say that's the total that they have refilled and as part of this refill effort. Now, that's a hefty sum. But I think detractors will reasonably say, well, 43 million barrels is a lot. But it pales in comparison to the 200 plus million barrels that the Biden Administration released as part of its emergency releases between the end of 2021 and the beginning of 2023, which is absolutely true. The challenge, however, with this is that the DOE doesn't actually have much money left. But where it will go? Because obviously they sold all this oil. The challenge is that, and I think we've discussed this before, that Congress had mandated a bunch of sales of crude from the SPR, essentially they paper over budget holes, they saw the SPR as a gigantic crude piggy bank. And part of what the Biden administration negotiated at the time, I think it was actually a really good thing to have done was, when they sold all of that oil, they exchanged the cash or most of the cash that they got

from that sale. They basically made a trade with Congress, they said you can have the money if you cancel these mandated sales going forward, because otherwise, you would have had another 143 million barrels of mandated sales that would have occurred between fiscal 2024 and fiscal 2027. So that would have brought us even lower, so they traded that.

The challenge is, is that now based on news with Deputy, an interview with Deputy Energy Secretary David Turk, who spoke with Bloomberg News earlier this week, he revealed that there's roughly $1.2 billion remaining in the SPR's petroleum account. And that's the accounting entity, essentially the line item that the DOE can use to purchase oil for the SPR. That's where all the money went from the sale. And that's essentially how much they have left. So $1.2 billion, it's a lot of money, but it's roughly only enough for about 15 million barrels of additional purchases. So now the question becomes if people want the Biden administration to continue refilling the SPR, they're going to need to recapitalize that petroleum account, then they need to put a huge amount of money in there to keep refilling, and I think as we've discussed before, as well, I see value in empty space in the SPR. I think that, let's say we have that scenario where OPEC completely opens the floodgates and the market crashes to below $50 a barrel and we end up in super contango when there are hedge funds chartering tankers for floating storage plays and everything else, that's the kind of environment where I think the SPR should be buying hand over fist, because that is, not only are they getting a great deal, but they're supporting market stability in the process. They're essentially helping close that oversupplied arbitrage opportunity. But to do that, they need money to buy oil. And I think even if we recapitalize the account today, and you don't use it, I think it's valuable to have that money sitting there. Because otherwise, let's say that happens in two months from now, let's say we haven't recapitalized the account already, well, then you need to go in this huge political debate around, give us the money, oh, well, we'll think about it, weeks pass, and you miss the opportunity to support the market at its greatest moment of need, and to get the greatest deal for US taxpayers. So I think that it is good policy now to plan for the future and to recapitalize the SPR, so that it can purchase more crude if market conditions warrant. I think that's this next debate. And you actually have seen that the administration has never, has never requested more money from Congress to do this. But obviously, this is an election year. And who knows, it's very unlikely that Congress is going to voluntarily hand up and gobs billions and billions of dollars of new money to the Biden administration for them to continue doing what at least the Biden administration considers to be a win for them, sure they released a bunch of oil, but now they fulfilled their promise, and they've continued to refill it. But they can only refill, like I was saying about a 15 million barrels, and then they're out of cash. So, we can only really have roughly three more of the purchases of this size before there's nowhere else to go. And I think that's the big challenge going forward is, if we want the SPR to be more active, we want the SPR to be more resilient to these market conditions, then we're going to need to fund it properly.

Erik: Rory, I really enjoy our conversations, you've got one of the most refreshing and thoughtful views in energy markets. And I guess that's no surprise, since that's what you do for a living at Commodity Context. Before we close, tell our listeners a little bit more about that, what services are on offer? Is it institutional only? Or do you have a retail product as well?

Who's it for, how do they find out more? And for people who are not subscribers to your work, how do they follow you just on social media and elsewhere in order to keep ahead of what you're up to?

Rory: Thank you for having me on, Erik. And I always enjoy these conversations immensely as well. People can follow all of my research at the moment at commoditycontext.com. I publish on Substack variety of thematic topics. I usually publish roughly twice a week on a variety of somatic topics, I have what I call data decks, which are big kind of data dumps and PDF packages of major things that I track in the market. And then every week on Friday, I have what I call Oil Context Weekly, which is my weekly wrap-up of all the big important things that happened in that week. You can also follow me on Twitter at @Rory_Johnston. And in terms of institutional package, I have actually begun building out and I should over the next couple of months have a product ready for institutions that are looking for higher touch coverage, much deeper on some of the things that we've talked about in this podcast and things that I write about at Commodity Context, as well as a data package, a lot of the data that I've cleaned and the data that supports my analysis in this work, and I'm now looking at working with different corporates to help advise them on how best to navigate these really kind of choppy and treacherous waters and again, an ever unprecedented oil market.

Erik: Patrick Ceresna, Nick Galarnyk and I will be back as MacroVoices continues right here at macrovoices.com.