Webinar: The Cartel Strikes Back: OPEC's Production Cut
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Larry Goldstein Comments

Q: Saudi's are cutting 2 million barrels a day. The actual cut, effective cut, might be closer to 1 million barrels. What does this mean for the oil market?

Larry:

It's not a production cut, it's a voluntary quota cut. And many of the countries' – including Russia's – current production is well below those current quotas. Which means they will not have to cut a single barrel to comply with this new agreement. Unfortunately, the media and the administration are couching what the Saudis did in purely political terms, as if this was designed as a move against the United States. I don't believe it was.

The administration is playing in the context of the midterms and the single-minded focus of gasoline prices. You'll see that in their response to likely cap the Strategic Petroleum Reserve (SPR) one more time. But what the Saudis did, what they had needed to do since mid-August – in August we put out several notes suggesting that we would be seeing a major cut in OPEC production at the beginning of the New Year. Why? Because when you look at the supply and demand balances from a fundamental perspective, stocks which had been declining every month this year would start to build by at least 1-1.5 million barrels per day, putting downward pressure on price. **OPEC had forecasted 3 million barrel per day growth in demand, our demand forecast is 2 million, the Saudis are closer to our forecast**, and they were going to cut. The problem was the cut was going to come later rather than sooner. What expedited the timing, and the size of the cut, was the obstinance and unwillingness of the US government and the EU to reconsider a very risky proposal on a cap on Russian oil prices. Many people read that, they see it in the times and WSJ and financial community, and they kind of dismiss it.

But what does a cap on Russian oil prices really mean? For the first time, it means a buyer's cartel would be forming, telling a producer what it can and can't do and what it could get for its price. We've had extensive conversation at a very serious level with the Saudis around this issue, they've been trying as hard as they can to get the administration attention on this issue and have failed every time they tried. What it means to them, is that if this buyer's cartel and the EU and the US have been meeting as recently as this week on the implementation of the cap on Russian oil prices is successful, then the Saudis are asking themselves if they can do this to Russia, who's next?

And the Saudi's do not want to see a successful buyer's cartel where they will be the 2nd target in mind. So, they speeded up the timeframe in which they were talking about a cut, **the cut is actually closer to one million barrels per day or** less – only the Saudis, Kuwait, UAE and Iraq might actually step up – and if you go to the OPEC communique, they're not talking about this as a production cut or a quota cut, they're calling it a voluntary quota cut. They are trying to get their act in line as to what they need to be doing as you move into 2023, what should be the appropriate quota targets, what should be the new baseline, and what should be the production targets in line. **The Saudi's have agreed to cut production by 526,000 barrels/day from the 11 million**. We believe by and large – not in November it's too early, the companies are already there nominating for the November liftings – it's too early for the Saudis to fully implement that size cut in November, but we believe they will do that in December, and they will follow through with their promise. **We believe Kuwait will follow through, that's about 700,000 barrels/day**. Iraq and the UAE will comply to some degree, and you can't count on anyone else. **The Russians will not have to cut one barrel**, which is why they were comfortable going along, because their actual production was already below the quota.

The principal thing is, we are overreacting. We're now talking about all the things we have to do to get back at the Saudis. What we don't understand, is the United States has many allies, and a lot of countries with commonalities of interest. We have commonalities of interest with the Germans for example, but he doesn't agree with them everything. We have commonalities of interest that are very important with Saudi Arabia, but we don't agree on everything. The Saudi's are an oil producer, we are still by and large an oil consumer. And our understanding conflict with one another there. The Saudi's do care about price, they do care about supply and demand, they want to be a reliable supplier, but they do not want to be dictated to by a cartel or any buyer as to what they can do, what they should do, and how they should price their oil. They reacted to the Janet Yellen proposal of this price cap, and unfortunately and we've had some conversation with people in government, they are not happy with my interpretation of things, but I believe, at the end of the day, our policy has pushed the Saudi's even closer with the Russians than they needed to be with this continuing mindless risky concept of a price cap on Russian oil.

Demand is running just shy of 100 million barrels/day. Supply in 2021 was just fractionally below that. At the turn of 2023, stocks are going to build, and it's very interesting because if you really study the market in detail, country by country, you see something: **prior to February 24th, at the start of the year, Chinese oil demand was forecasted to grow at 500,000** barrels/day. China oil demand because of CVOID and lockdowns will probably decline 3-400,000 barrels/day. So that's a **swing in demand just in China alone of 900,000 barrels/day**. This was not lost on the Saudi's**. We're seeing a lower decline in demand in the U.S., from initially the EIA forecasting of 600,000 barrel/day growth to now 300,000.** Gasoline demand in the 2nd half of the year, we've been forecasting will decline 6% despite the fact that it grew in the first half of the year. **So far in July August and September data totally supports our 6% decline**. Demand is coming off. Diesel demand is a suspect product, its demand is growing where you can substitute very high price natural gas in Europe, its declining everywhere else. So, the Saudi's are very sensitive to watching the decline in demand continuing to occur, and they were looking to cut production in any case by 1 million barrels/day. **The 2 million cut they talk about really interprets to 1 million**. They just speeded up the timeframe and got the attention of the administration because of the timing of when the administration and the EU is going to make a final decision on the price cap on Russian oil. That decision is going to be made over the next couple weeks, and the Saudi's are paranoid about that.

Because of the misinformation, some of it deliberate, following February 24th, there was story after story after story that Russia oil production and exports were declining 1.5 – 2million barrel/day. Ed Morse from Citibank was the only calming analyst around, who basically said I hear what you're saying but I don't see what you're saying, and he was right. The U.S. can try to push the increase in gasoline prices from February 24-September on OPEC, on the U.S. producers, on the gasoline refiners or retailer, on Russia, but **ironically, up until this past month, Russian production of oil has hardly changed, its off about 600,000 barrels/day**. So, if that's all you lost, you can't pin the big increase in gasoline prices on Russia. You can pin the food and agriculture and neon prices on them, they are Russia-led in terms of inflation, but not gasoline. **Gasoline prices in the U.S. were up $1 before February 24th, and inflation was already up 7% before February 24th**. So, while a lot can be pinned on Russia right now, gasoline prices is not one of them.

Oil prices recently went down to 76 and now they are close 90, from a recent peak of around 120 in late February and March because of the fear that we had already lost 1.5-2 million barrels of Russian production, which we didn't. We will start to lose Russian oil, but we haven't really lost it in size up till now, what you've seen is a diversion of about 1.5-2milliopn barrels from the West to Asia. The Russians are discounting their oil there by about 25$ per barrel, they are absorbing the much higher transportation costs, but they have no trouble selling primarily to India and China. **China was importing about 900,000 barrels/day of Russian oil before February 24, they are about 1.7 million now. India was about 100,000 barrels/day, they are over 1 million now**, because of the big discount. One of the problems the US might have on trying to implement the cap on Russian oil is to get the Indians and the Chinese to go along. The Indians have said look, we aren't buying "Russian" oil, we're buying "cheap" oil. And people will do what's in their self-interest, so they will likely continue to buy Russian oil.

On the SPR, the petroleum industry research foundation, in 1971 we met with Henry Jackson the chairman of the Senate Energy Committee. US production had stagnated, and demand was growing 5% per year. Our growing dependency on the Middle East was going to create down the road some vulnerability to a disruption. We convinced him to look at putting oil in the Gulf coast. He loved the idea, but it took an Arab embargo in 1973 and 1975. The purpose of the SPR was to minimize economic dislocations during legitimate supply disruptions, not to dampen gasoline prices. We have had a total misuse of the concept, and ironically, and I didn't get into this because it's a minor point, the Saudis told us that they are concerned that they can't foresee what will happen in the next 12 months with Russia, Iraq, Libya, Iran. They don't know about the disruptions that can and are occurring. So, they are concerned about the lack of spare capacity. So, by cutting now, they build a little bit of a cushion. The irony is they are building a cushion to respond to an emergency, we're drawing down our tool to respond to an emergency.

Q: After this voluntary cut, what would the Saudi's spare production capacity be?
Saudi's are claiming that they can produce on a sustained basis 12 million barrels/day. They've never been tested on that number. We do not know that or believe it. But the official public statement which they put in their SEC filings which therefore you have to take seriously, is 12 million per day. So, under this cut, if they adhere to it, they would be at 10 million rounded 500,000, that will give them 1.5 million of spare capacity, compared to about a billion now.

Countries operate in their self-interest. Germany is a perfect example; we've seen what they've done with their nuclear units. In 2021 they closed 3 of their last 6 nuclear units, they were begged not to do that. They have 3 more now, they're suggesting they may keep 2 of them on standby. They are looking out for their self-interest. This was not a targeted policy designed to get the U.S., it was designed to get the U.S. off this really potentially dangerous concept of this cap. What we do know, and you have to take them seriously, is Putin's statement that any country that complies with the cap will not get any oil. That means the Russians will cut production at a time when you do not have the ability to make up that production. Janet Yellen and the U.S. are playing with fire, they know and were told that but are ignoring it. That is why the Saudi's did what they did. The right will interpret this as a failed Biden policy in the Middle east, they'll play it as hard as they can in the midterms. The left will play it as the Saudis and OPEC are responsible for gas price increases not us, don't blame us, and it will play out in the politics not in the reality of what's happening.

In January, the **Saudi production was close to 10 million barrels/day, in October it was 11**. **Their production went up almost 1 million/day**. The administration talks about **US producers not doing anything, their production will be up 6, 7, 800,000 barrel/day and the EIA is forecasting another 800,000 barrels/day next year**. That didn't come by magic or out of the air, it came by drilling, even with limited access to permits and the fact that the administration refuses to put new acreage out there for the industry to bid on.