The politics of oil

When it comes to controlling the price of oil, the Saudi Arabia led OPEC+ decision to announce a further cut in oil production is part of a wider and on-going pattern of disengagement from the United States. Inevitably, the consequence of this decision may have serious repercussions on western relations in the Middle East, and for the price of oil going forward.

Unlike the previous announced cut of two million barrels of crude oil in 2021, which was more focused on trying to achieve OPEC's stated production targets (where the two million headline number turned out to be closer to 800,000), this move by Saudi Arabia appears to be a genuine attempt at resetting oil prices.

West Texas Intermediate Crude Oil Future price ($ per barrel) (front month)

Source: Collidr

It is probably fair to say that Saudi Arabia do not like oil price volatility, especially the volatility that has taken place these past few years, and they defiantly resist the idea of oil falling below U$80/bbl.

Even if OPEC+ cannot directly set the price, the increasing market share of Saudi Arabia and the United Arab Emirates (UAE) within OPEC, as well as the acquiescence of Russia to Saudi Arabia's leadership of OPEC+, means that Saudi Arabia can increasingly influence the price of

Symon Stickney
Group Chief Executive, Collidr

www.collidr.com
hello@collidr.com
+44 (0)808 281 2900
Connect on LinkedIn
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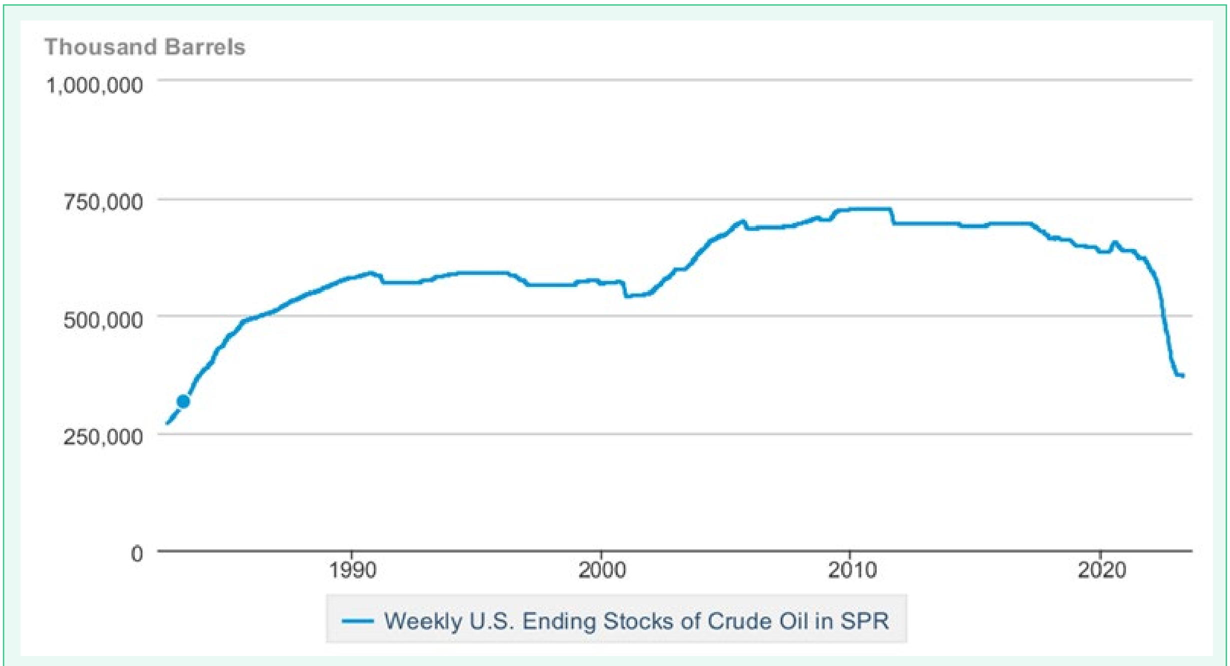
oil. This production cut tells us that Saudi Arabia wants to see a higher price, well above the US$80/bbl the markets are currently pricing.

At this stage, when it comes to energy policy, it is not unreasonable to expect a further deterioration in Saudi-US relations. Not long ago, the enticement of US military and security guarantees meant that Saudi Arabia was the moderate voice within OPEC, reining in more aggressive price-sensitive members, such as Iran, Libya and Iraq. However, Saudi Arabia has had a strained relationship with President Biden, one dating back to the Arab Spring in 2011. Then, President Obama and Vice-President Biden provided little support to the Egyptian President, Hosni Mubarak, paving the way for Egypt to be led, for a short time, by the Muslim Brotherhood.

The US-Saudi relationship deteriorated further over the death of the journalist (and Saudi dissident) Jamal Khashoggi in Turkey, a crime in which senior levels of the Saudi government (and royal family) have been implicated as sanctioning.

From a Saudi Arabian perspective, Biden is a hypocrite when it comes to the price of oil – on one hand, criticising OPEC for production cuts, yet, in turn, flooding the market with the US Strategic Petroleum Reserve. An act compounded, no less, by refusing to honour his pledge to refill it when prices fell back.

Weekly U.S. Ending Stocks of Crude Oil in Strategic Petroleum Reserve (SPR)



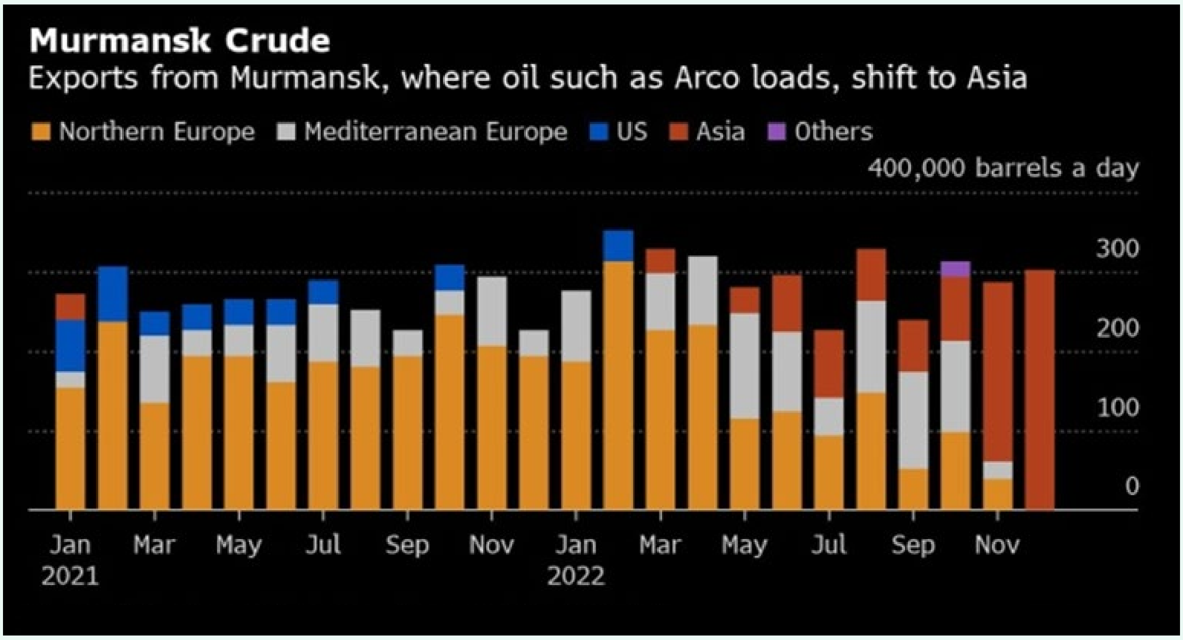
Source: U.S. Energy Information Administration

For Saudi Arabia – who have seen the price of oil fall sharply on the back of financial market conditions rather than any fundamental weakness in oil demand – this may have been the final straw.

Which brings us to the Chinese brokered agreement to restore diplomatic relations with Saudi Arabia and Iran. Although it received limited media coverage, this agreement could be hugely significant. In the past, China's foreign policy has focused on matters that directly affects their interests. But here they were, bringing two sworn enemies together. For all their political and fundamental differences, it was the Chinese, not the Americans, who brokered the deal. Alongside the OPEC announcement, these actions show just how fragile and misaligned US-Saudi relations are.

By all accounts, Saudi Arabia has been a bystander to the Russo-Ukrainian conflict. They are unhappy with the volatility that it has brought to the price of oil, as well as the disruption it has contributed to long-established oil trading patterns. Furthermore, the surge in Russian oil exports to Asia has been at the expense of Middle Eastern producers.

Murmansk Crude



Source: Bloomberg.

One simply needs to look at the price of Dubai crude versus Brent as a sign. China does not want to become too reliant on Russian crude imports, but displacing Saudi and UAE imports with Russian supplies has given them some leverage. So, keep an eye on any longer-term Chinese oil and LNG agreements with Middle Eastern producers as further proof.

What we expect to see now are more resilient Russian oil supplies, a further deterioration in Saudi-US relations, and a greater willingness of China to become politically engaged with OPEC. As a result, we may see the Saudis price some of their sales to China in Yuan, perhaps as part of a long-term supply agreement, and possibly, the start of a move away from the US dollar as being the dominant currency for international trade and settlement in oil.

However, any move in this direction will take a long time to play out, and we do not envisage a challenge to the US dollar's international dominance in the short or medium term. What this does show, nevertheless, is that Saudi Arabia is prepared to pursue policies that do not have the support or approval of Washington from this point on, and we will move to uncharted territory with how they engage with one another.

For now, expect Saudi Arabia to be in the driver's seat with regards to controlling the price to oil, and for more turbulent times ahead as the markets react to this potential new world order.