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Letter From Riyadh: Aftershocks

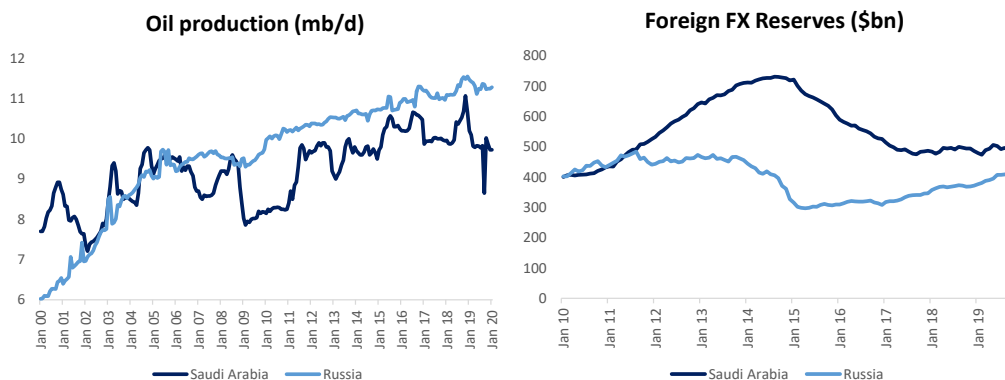
Global Commodity Strategy and MENA Research

The mood in Riyadh was grim as the leadership prepared to ramp up output in an effort to bring Moscow back to the OPEC bargaining table. While OPEC leadership retains hope that the price collapse will be a catalyst for a reconciliation between the two oil heavyweights, President Putin may not quickly capitulate. We fear that it could be a protracted struggle, as Russia’s strategy seems to be targeting not simply US shale companies— but the coercive sanctions policy that American energy abundance has enabled.

As we landed in Riyadh [on Saturday night](#), the aftershocks of the disastrous OPEC meeting were beginning to be fully felt. When HRH Prince Abdulaziz left the OPEC Secretariat on Friday evening he told reporters to wait and see what the Kingdom’s response would be to the Russian decision to block the proposed 1.5 mb/d production cut. The move to dramatically slash OSPs less than 24 hours later was the emphatic signal that the Kingdom was commencing a fierce campaign to wrest market share away from Moscow in an effort to alter the decision-making calculus in the Kremlin. During our 36 hours in Riyadh, it was made clear to us that the central banker of oil was preparing for a swift and substantial production increase that could retest the 2018 highs of just over 11mb/d. Despite the huge fiscal costs that such a policy entails, Saudi Arabia seems determined to keep the spigot open until Russia agrees to rejoin the 23 other OPEC+ producers and participate in a massive collective production cut (which could balloon out to even 2 mb/d) to try to address the demand impact of Coronavirus. Prince Abdulaziz has been calling for urgent action to get ahead of the crisis for the past six weeks, seeing it as potentially more destructive than the 08-09 financial crisis. And yet when faced with repeated Russian intransigence—which began with the rejection of an early emergency OPEC meeting in February—he held the line that Saudi Arabia would not bear the burden of adjustment alone and that they would all deeply regret the failure to act in Vienna.

The Secretary General of OPEC and several other powerful member states continue to hold out hope that an accommodation can be reached quickly and that the price collapse will be the catalyst for consensus. OPEC’s Joint Technical Committee is reportedly scheduled to meet by teleconference on March 18. In addition, Russian Minister Alexander Novak still seems to be held in high regard despite having to deliver the hard no last week and publicly announcing that it would essentially be every producer for himself at the end of the month...

Figure 1: Saudi Arabia & Russia oil production & FX reserves



Source: Bloomberg, Energy Intelligence, RBC Capital Markets

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...Blame for the Russian decision is instead being laid at the doorstep of Igor Sechin, the powerful CEO of Rosneft, who seemingly persuaded Putin to privilege eviscerating the US shale industry over maintaining lucrative financial relations with the gulf states. The US decision to sanction Rosneft trading likely played a critical role in altering the policy course in Moscow. For now it seems that Sechin is not seeking to eliminate simply the market share of US shale producers, but the aggressive US sanctions policy that American energy abundance has enabled. Trump administration officials have repeatedly bragged about the ability of the US to punish its foreign policy adversaries by sharply reducing their oil exports, and to be shielded from the price impact because of abundant domestic energy supplies. Like Putin, Sechin hails from the Russian intelligence services and is a strong nationalist. Undercutting American energy dominance therefore most likely appeals not only to his bottom line but also to his ideological affinities.

It remains to be seen how much economic pain Vladimir Putin will be willing to accept in pursuit of Sechin's strategy. There will likely be opposing voices in Russian leadership circles, who view the world through the lens of investment opportunities and retain strong back channel lines of communication to the key gulf states. However because Sechin's strategy is about more than just oil—and instead the global balance of power—it could be more enduring than the rest of OPEC hopes. In Riyadh there was no joy about what has come to pass, only grim determination. There are no illusions about the incredibly arduous path ahead, which is only being made more fraught by the toll the virus is taking on the region. As we were leaving, the government had announced that schools were being temporarily closed in the Kingdom. This followed a decision to close land borders with neighboring countries, a move which imposes particular hardship on Aramco employees living in Bahrain. Hope remains that this battle will be short, but preparations are seemingly being made for a protracted war of attrition that could have brutal economic consequences for all involved.

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