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RUSSIA AND SAUDI ARABIA KEEP TALKING, BUT WHO'S LISTENING?

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By Liam Denning

Some important news today from Russia on the future of oil: Scientists there have reportedly discovered a new method of fracking that has boosted output from wells six-fold.

Now, a word of caution on touted Russian oil breakthroughs: Some Russians claim their country invented fracking -- a dubious assertion and one you would be well-advised not to raise in polite conversation if you happen to be in Kansas.

Even so, as Thane Gustafson relates in his epic history of the Russian oil industry, "Wheel of Fortune", the Soviet Union's petroleum engineers did try something those Kansans never attempted; namely, trying to frack in the Arctic with nuclear explosives (go big or go home, amirite, comrades?) Unfortunately, rather than break apart the rocks and unleash a torrent of oil, this bold experiment merely fused them into a reservoir of ... toxic glass.

And you thought the Permian basin was a challenge.

The more pertinent news from Russia on Tuesday actually concerned comments from the country's energy minister about having discussed with Saudi Arabia a possible extension of the oil-supply cuts led by the two countries. You may remember these were announced last November by the so-called Vienna Group to kick-start a recovery in oil prices. With little to show for it by the end of May, those cuts were extended to the end of March 2018. Now it seems the extension may get an extension of its own.

Not Great Fracking Tools

Nukes

It is difficult to know how much impact the minster's words are having. Oil prices did rise a buck or so on Tuesday morning, but that probably had more to do with some Gulf Coast refineries switching back on after Hurricane Harvey.

The fact is, like a piece of well-chewed gum, the muttered asides of Vienna Group ministers about extending supply cuts have lost their potency through excessive use. Meanwhile, Hurricane Harvey has not only just served to remind everyone that U.S. oil is now a serious competitor in the global market, but has also messed with Saudi Arabia's strategy for rebooting prices.

With less than seven months until that seemingly squishy March deadline expires, the Vienna

Group is fast approaching a moment of truth.

Simply extending the cuts looks pointless and may well be counter-productive. Russia, as I wrote here, is an unreliable long-term partner for Saudi Arabia, especially once the Kremlin gets past presidential elections scheduled for ... March.

Moreover, whatever rhetorical power is left in those hints of continuing supply cuts will tend to accrue to competitors, particularly U.S. exploration and production firms seeking to hedge their future output. A big reason why the Vienna Group's initial announcement failed to lift oil prices on a sustainable basis was that it touched off an initial jump in futures prices that enabled a hedging frenzy on the part of E&P firms, keeping them in the game:

At this point, while rumors of cuts appear to do little for spot prices, they may yet support prices further out, particularly as the timelines get extended. This is of more benefit to shale producers than the Vienna Group's members.

In a way, despite its questionable claims, that story about the Russian shale breakthrough is a warning to the Vienna Group.

Even if it amounts to nothing, it represents the longer-term threat to Saudi Arabia and Russia if they continue along their present course. The shale breakthrough, and the productivity drive it has sent rippling across the oil industry, along with demand-dragging efforts around things like electric vehicles, are a recipe for persistently lower oil prices. Keeping oil prices higher than they otherwise would be provides scope for further advances.

The rational thing to do would be for large, low-cost producers such as Saudi Arabia to maximize output and drive oil prices down to a level that both stops the flow of capital into U.S. fracking and spurs demand for more barrels. This would ultimately result in tumbleweeds in the Texan shale fields and similarly devastated industries in Canada's oil sands, Brazil's deepwater fields and elsewhere, allowing the likes of Saudi Arabia to reassert their dominance in a growing market.

In a report published this weekend, energy economist Phil Verleger analyzed two scenarios for the oil market: a "best" case for low-cost oil producers in the Middle East where they maximize production and let prices fall for a while, and a "worst" case where they keep trying to manipulate prices higher. The latter sees their collective market share drop from 25 percent to 16 percent by 2022 -- while demand barely rises.

To embrace the best-case strategy would, of course, represent another u-turn on oil policy for Saudi Arabia since 2014. Given it would also constitute an effective death sentence for the likes of Venezuela, it would also mean the end of OPEC itself. Above all, while Saudi Arabia appears on paper to have the cash reserves necessary to wage such a scorched-earth offensive, the kingdom's need to appease its populace while it embarks on a radical reform program suggests the numbers alone don't capture the full story. Plus, of course, there's a certain giant IPO requiring optimism about oil prices to consider.

There are no easy options at this point. But just talking about it clearly isn't going to cut it.

Kaynak/Source: