MACRO Voices
with hosts Erik Townsend and Patrick Ceresna

Rory Johnston: Crude Oil Update: Fundamentals, Geopolitical Risks, and SPR

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Erik: Joining me now is commoditycontext.com founder Rory Johnston. Rory, it's great to get you back on the show. It's been too long since we talked about crude oil, which is your specialty. Let's start with the big picture. Before we dive into the alphabet soup of of Middle East and various other geopolitical risk factors, let's just talk about supply and demand OPEC's participation of Chinese economic recovery and what that means for demand and so forth.

Rory: Thanks for having me back, Erik. Obviously, this year has been, it took a little while to get started. But it's become a very bullish first half of the year, with prices rising from the kind of mid 70s up towards $90 a barrel, Brent. So I think that is, by all intents and purposes, kind of a very strong crude number in this current environment. And that's been driven by kind of developments over the first half of the year, mainly around declines in inventories. So we've had this kind of realized tightening of the fundamental side of the market. At the same time, as those realized fundamentals or kind of inventory drawers have occurred, you've also seen a gradual tightening of the outlook for the rest of the year, mostly on this idea that demand is starting to look a little bit better than it did a couple months ago. And the fact that I think now the expectation is that OPEC will keep these cuts in place for longer and kind of defend higher prices. So I think that combination of factors has allowed the market, you know, it reflects the market has already tightened and expects a further tightening of the market.

So on top of that, as these prices have kind of rallied higher, you've also begun to bring in a lot of speculative and kind of momentum driven trading, that further push those prices up. So right now, just to kind of give a complete lay of the land, we have reasonably decent inventory positions or reasonably bullish inventory positions, globally are visible inventories, we have a reasonably tight outlook for the market, assuming that demand doesn't falter on some broader macro pullback, and OPEC remains disciplined in its cuts. At the same time, right now at around $90, we do have a lot of speculative or hot monies further supporting these prices. So I think on a fundamentals basis, I've been saying that we've been fundamentally supported, but speculatively driven in this rally. And I stand by that, I think that the immediate near term risk is a kind of a sudden pullback in these prices as that momentum wanes, and as those speculative dollars have inevitably begin to take profits. So I see that we could pull back there. But then after that, we're left probably still in the mid 80s, on a Brent basis with this kind of fundamental backdrop. So I think that's probably where we're standing. And on top of all of this, as we'll talk about at length I’m sure, is all of these varied and very, very difficult to quantify and kind of wrap your head around geopolitical challenges from Iran to Russia and everything in between.

Erik: Let's just go a little bit deeper on the OPEC side of this. I agree with everything you said. The one thing that occurs to me is when we've discussed these markets in the past, I think what you and I have agreed on is, when you go from not just bullish, but uber, uber bullish is when you get a situation where OPEC, it's not a question of what they want to do, but what they can do. So when they're running out of spare capacity, that's when you've got a really critical, potentially explosive upside price situation. I don't think we have that. Now. It seems to me like although OPEC is staying disciplined on their cuts, as you said, if they wanted to, if they became concerned that prices were too high, they've got lots of room to release more oil. Am I wrong about them?

Rory: No, you're absolutely right. And on a kind of a headline basis, we're nearly 5 to 6 million barrels a day of cuts currently on the books. Now, that's kind of paper barrels, I think more on a realized basis, you're probably talking more like 3 to 4 million barrels. But that's a lot of supply being held off the market. And just to kind of draw, I think, an important perspective on just how large a support that is, excluding the COVID intervention, which I think we can all agree is a particularly exceptional, non-usual market environment. Excluding COVID, this kind of 3 to 4 million barrels a day of cuts that OPEC is currently holding off the market is the largest cut or the most support that OPEC has been giving the market since the financial crisis in 2008. So we're at kind of 2008 crisis level support for the market. And I think in arguably a much stronger economic environment. You know, while growth may be flagging in some areas, we're certainly not in a global recession and in many areas in the US outperform. So the fact that demand last year grew by more than 2 million barrels a day, which is a really strong year for demand growth in any environment and in that backdrop, we still have OPEC supporting the market to this degree is I think, a reason to be cautious and I think you're absolutely right. Right, that at the end or kind of or the mid beginning to mid of 2022, a lot of what helped push us to those really, really high prices was this combination of tight markets and this concern that OPEC was beginning to miss its production targets. And it was under producing what it said it would and it couldn't bring crude back to the market.

So I think you're absolutely right, that was the catalyst to really pop us higher than now. We have lots of different cuts to work through in different tranches of cuts within OPEC. So I think the big question now is, let's say we go in this kind of bullish direction, let's say everything goes that kind of oil bulls’ way. Now the question is, at what price does OPEC think that it should begin easing back into the market? And I think when you look, historically, I just published on this a piece called OPEC price. And when you look at pre COVID, essentially, OPEC cut to support the market in the kind of high 40s to mid 50s barrel on a Brent basis. Whereas in either this latest cutting cycle that began at the end of 2022, they started cutting at $90 a barrel. So I think you can never fully know exactly what is in the mind of OPEC ministers. But you know, through the idea of like revealed preference, you can see what they do, at what point. So I think at this point, you can at least say they want probably at least $90 a barrel, if not higher. And given that prices don't just trend in a straight line, they're going to tolerate a good amount of chop to the upside. So I think now you're looking at probably, you need to get into the low triple digits for a decent period of time before I think OPEC would consider accelerating what is currently their planned next kind of major off ramp date, which is the end of June. So absent something that goes well, you know, $105, $110 a barrel Brent, I don't think they're going to waver on that. I think even if we stick in the low, you know, right where we are right now, 90 to the high 80s. I think as a chance you could see some of those cuts, if not all of them extended further through the end of June. So I think at this point, OPEC seems to be in the higher for longer defense game.

Erik: How much spare capacity do you think exists worldwide? And what's the breakdown between OPEC and where the other sources are, and just to be clear, I'm not asking what the producers are reporting. I'm asking Rory his opinion on the real numbers.

Rory: Yeah, so I think realistically, I think you basically have that kind of 3to 4 million barrels a day of OPEC, current cuts. And that's predominantly held by Saudi Arabia, that's 2 million barrels of that, in totality is Saudi. And I think on top of that, maybe you have 750k to a million barrels a day of Saudi on top of that, and probably a similar amount of Emirati or UAE, crude, basically, that's it, there's nothing else. That said, I think that that's a lot of crude oil. In this current environment, you're talking probably ballpark 5 to 6 million barrels a day of current kind of spare capacity writ large, with some of those being active cuts, and some of that being kind of stuff that just wasn't part of these baselines and deals. But like you said, that's a good amount of cushion to the upside. Now, the challenge is, if you think in prior market environments, it would be crazy to think that we had prices in the 90s. And OPEC was still withholding, let's just say for ease 5 million barrels of spare capacity from the market. That's a lot of markets forward price in the 90s. So I think itself speaks to the fact that we are in this higher price regime. And I think I've really been pressing and kind of reinforcing this point that, yes, markets are tight right now. And yes, they are expected to continue to be tight. But that is an artificial tightness that is a specific discretionary policy choice, most notably by the Saudi government and Riyadh to keep this market tight and to keep these prices high.

And I think the important thing, the reason why I've haven't always done this, because, you know, these countries derive the vast bulk of their income and everything from crude oil. So you would think they always would want really, really high prices. But historically, there have always been a variety of pressures with holding them back. Most notably, high prices incentivize additional non-OPEC supply growth. So last year, when they first embarked upon these, this kind of higher price defense, everyone was really sure that the pace of US shale growth had slowed, that we were between the supply chain bottlenecks and technical difficulties we saw in 2022 and promises and commitments of a return to cashflow discipline and the kind of return of capital to shareholders after a disastrous decade of shale overspending. OPEC thought, and specifically Saudi Arabia thought they could get away with prices at those high levels and not see a massive outperformance of US shale production. But, essentially, looking at last year's numbers where the forecast began the year and where they ended up coming in, you're looking at upwards of 50% to almost a doubling of initial expectation for last year's US shale growth, which is in the ballpark of 1.5, 1.6 million barrels a day of total liquids in the United States.

That's a massive, massive year of growth. This year, the oil bulls have kind of been saying that, don't worry about 2023, it was a flash in the pan. It was privates kind of trying to juice their acreage to look more attractive for you know, buyouts, et cetera, et cetera. And, you know, at this point, it seems like OPEC is kind of believing that and the EIA’s latest outlooks for US crude production dropped from last year as insanely high 1.6M to something more like 300,000 barrels a day. So an 80% reduction in the pace of US shale growth, that I think is one of the most important things for continued compliance and kind of unity of OPEC, is that we can maintain these high prices and not see a return to gangbusters growth in the United States. Because if you do, then I think you begin to increase the risk of a disorderly collapse of the production deal, because people will begin to cheat and there's a feeling, particularly in Saudi, that you would need to fight for market share, and that $90 a barrel isn't sustainable. So I think that's this kind of near term worry. And then across the broader, I think the single most important backdrop is demand. How much will demand grow this year, there's right now about a million barrels a day of difference, almost double, between the IEA’s latest demand outlook for the year for 2004, which is 1.2 million barrels a day, and OPEC’s 2.2 million barrels a day. That delta is essentially entirely slack for OPEC, if you only get 1.2 million barrels a day of growth, it's really hard to see how OPEC is going to materially ease those production cuts this year. But if you get 2.2, well, then we can probably wind off most of this latest cut, and kind of be on this path to normalization.

Erik: There was another development out of Riyadh, which in my opinion was under reported on, which is that for years and years, the Saudi production capacity was reported at 12 million barrels per day, to increase to 13 million barrels per day with additional investment. And then Riyadh announced we've changed our mind, we've decided not to make that additional investment. So we're going to stay at 12 million barrels a day and not increase it. And it was a little bit ambiguously worded, but the way it came across to me, it sounded like they were making a permanent announcement like we are never going to increase beyond 12 million barrels a day, regardless of what the market does. Do you agree with that interpretation? And if so, is it significant, in terms of, you know, it sounds to me like the Saudis are really following through on what they've said, which is diversifying their business activities beyond petroleum, and not necessarily focusing only on the oil market as their national revenue source. If we did see increasing prices, do you think that Saudi stays at their current production capacity? Or do you think they'd make that additional investment to try to get up to another million barrels a day beyond whatever they have now?

Rory: So I agree with you that it was, the delay or to announce kind of cancelling of these expansion plans was very significant. I don't know if I see it as a permanent state, I think there was, I can't remember the exact quote, but there was a quote from a Saudi government official that basically said it was the energy minister who said, this isn't necessarily permanent, like if market conditions change, we can go that direction. But I think it's going to take a lot to get them to kind of restart those plans, I think. And to this point that I was saying earlier about the scale of current cuts, it makes sense that if you have, you know, Saudi alone probably has three plus million barrels a day of spare capacity right now, why would you invest in expanding that capacity that in this climate where you don't know what's coming around next year? I think what everyone has learned in the oil market right now is that, you really don't know what's coming next year, each year has been a complete curveball in this kind of volatile environment. So I think it makes total sense that they're not just going to kind of add to that pool of spare capacity. But I think it also does kind of say that, like they don't expect to see a major difference, or they don't expect to see major need for that spare capacity in the immediate term. So you know, you can read it as you're going to read it in two ways. You can either read it as bullish, to say, oh, well, look, you know, Saudi isn't going to come to the markets support, and it's going to kind of keep these prices tighter for longer. And on the bearish side, you can kind of say, well, this is Saudi recognizing or acknowledging that you probably won't need Saudi supply to that degree. And I think, the Saudi would probably argue it's the bullish interpretation. But I've seen lots of kind of people taking the other view as well.

Erik: One last question on the fundamentals before we dive into the geopolitical conflicts. It's always appeared to me that the big picture of this oil market is, we're in a pretty stable condition until the US shale plays have played out and there's no longer capacity to make up for declines in the rest of the world by growing the US shale patch. Are we starting to get there because it seems to me like you know, before the pandemic we peaked out at 13.3 million barrels per day on the weekly US EIA data reports, we got up to that same 13.3 million barrel per day, peak post pandemic. Now it's sold off by a couple of 100,000 Barrels just to 13.1. So it's not like it's in a deep retreat, but it's not increased beyond that level either. Is that going to be the peak? Do we have capacity for US shale to grow significantly beyond where it is?

Rory: So I think you can, I think it's going to require prices to remain at these higher levels for a little bit while longer. The one caution I would make is that I typically don't look at the weekly production numbers, and actually wrote a piece specifically on this kind of debate between weekly and monthly production numbers. And the weekly numbers are more or less, the EIA’s almost interpolation, not even a forecast per se, of their latest kind of monthly numbers. And that creates a lot of confusion. And I encourage everyone to read that piece, because I think it's a really, really interesting kind of technical and statistical parsing of those two data series. And I think the weekly one gets a lot more attention, whereas actually, there are a lot less information there. But you know, this is just maybe being a wonky and pedantic here. But to answer your core question, I do think that production hit a slightly higher number, and again, from the monthly data, you hit a peak of 13 million barrels a day of crude production in November of 2019. And you kind of hit this new peak of just around 13.3, which is again, dovetailing with the weekly numbers in December of this past year, then you had the massive winter storm effects that brought us lower in January and likely February as well. And now we're kind of crawling back up. And what I thought was really interesting is, when you look at the EIA’s latest STEO outlook for crude oil production, it takes until like the end of the summer for us to act in that forecast to get back to those previous high levels. I don't think that US shale is tapped out. Yeah, I think that what we have seen is obviously an increasing cost sensitivity in the patch, you've seen, even in the past three years, the Dallas Federal Reserve publishes its own kind of cost estimates based on surveys with its member companies. And those estimates show just baseline, a $15 average increase in cost of production across all the major plays. So I think that itself, I think, speaks to this kind of generally higher price sensitivity, or at least higher price benchmark and threshold, which I think also helps support what I was saying earlier, about OPEC feeling a little bit more comfortable with these high prices. So clearly, we're not seeing a boom in drilling activity right now. But I think you continue to see increased productivity. And that I think, was the surprise last year. So I do not see the peak behind us. I think the peak of US production on a crude, overall basis, and even in the Permian Basin specifically, will continue to rise, particularly if we see prices this high or higher for a prolonged period of time.

And the other thing I will say is, I do think it's important also on the non-US, non-OPEC, the rest of it. And there, you really have three countries that always come up, you have Canada where I'm at. Canada, then Guyana, and Brazil. Those countries, each of them, Canada's probably, you know, this year could add 150,000 to 250,000 barrels a day on both, you know, wildfire based test of last year and the startup of TMF, which is really exciting, Canada's first kind of quasi new pipeline in forever. So that will allow some new crude to come to market. Guyana, you're probably going to have an average growth of something in the ballpark of 150,000 to 200,000 barrels a day each year going forward, between now and essentially the end of the decade. And then Brazil, probably 200,000 to 300,000 barrels a day, should Lula not completely mess up Petrobras' trajectory. That I think, you know, just those three countries together, you're looking at probably ballpark, what is that two, three, and you know, was 600,000 to 700,000 barrels a day. That's a decent chunk of crude production that is far less price sensitive than US shale, these are much longer lead time projects with generally, at least in Guyana and Brazil's cases, lower cost breakevens. So even if we had prices that weren't super supportive of US shale, you still have the rest of that non-OPEC supply that OPEC kind of needs to contend with. So I think that's in particular, why getting demand growth, kind of higher than the IEA's current expected 1.2 million barrels a day. Even if you cut the United States out completely, you leave it flat forever, you know, that still takes up more than half or half or more of that demand growth just from those structural non-OPEC, non-US growth centers. So that's why you really need to get like to 1.5 to 2 for OPEC to begin to feel like it has the room to kind of more flexibly begin easing, easing these cuts while maintaining a tight market. Otherwise, I think they're going to keep remaining on this back foot of, they might begin to ease but then you know, demand slows and cuts them off. So I think that's, you know, well, US supply response is really important. I still think the most important thing for OPEC is essentially who wins the demand debate for this year? Is it a low growth kind of IEA? Or is it a high growth OPEC? And I think the most ironic factor here is that there are a bunch of quotes of Saudi Aramco's own expectation. of demand growth this year, and it was at like 1.5, 1.6. So it's really fascinating to me that Aramco is in the middle of those two and isn't closer to OPEC, although you have seen a lot of people coming in with really bullish forecasts, I think, most recently, the FT had a quote from Vitol, the world's largest independent oil trading company, that was seeing demand growth at 1.9 million barrels a day. So if we have a near 2 million barrels a day demand growth market again this year, I don't see really any situation where it's not continuing to be bullish, unless US shale completely doesn't about face and rocket tire.

Erik: And again, that piece on monthly versus weekly production figures is available at commoditycontext.com. Rory, let's move on to the big elephant in the room, which is, of course, the geopolitical conflicts. Let's start with Iran and the Middle East.

Rory: The first thing I'll just say is, it's always really hard, everyone talks about how much geopolitical risk is in the price of oil right now. And it's important to note that, like how geopolitical risk would manifest in price formation in the first place, because it doesn't happen in a vacuum, it always has to be through buying and selling of either physical or financial crude contracts. So we have two ways of doing it. Either you can have speculative participants that drive the price up on an expectation that prices will rise because of let's say, the conflict continuing to spiral out of control, or you have physical players that, you know, in the literature, they talk about, "precautionary demand," which is essentially front bar or front loading purchases for fear that you're not going to get even, you're contractually obligated barrels down the road because of some disruption. Now, the challenge here, and I think that the challenge the market since the horrific October 7 attacks, and Israel has been trying to figure out exactly what the vector is for a spiral from an Israeli centric crisis at the moment towards broader oil market, which means essentially, you would either need to impact Iran, which is where we will get in a second, or kind of something more broadly with, you know, broader regional instability and Saudi getting involved somehow, because obviously, Israel itself and Gaza in particular does not have any oil or petroleum industry to speak of. So when we think about Iran, I think there's two main questions. One, could there be some direct impact to Iranian crude or refining production facilities or export facilities? Or could Iran take the, terrible to use the nuclear option here, because that's a very specific thing in Iran, but I think the most dramatic action, which would be the classic shuttering of the Strait of Hormuz. I think most analysts you speak with these days, discount the probability or even possibility of a straight up closure of the Strait of Hormuz, because it would just be the ultimate, it's kind of self-defeat of Iran, because Iran obviously depends on that passage for a huge amount of its own exports, most of which is going to China. So obviously, China will be very displeased with the closure of the strait as well, as well as it would prompt, obvious and ferocious pushback from other Gulf neighbors, you know, Iraq, Kuwait, UAE and Saudi Arabia, which all ship various, huge amounts of products through that area as well. So I think that would be the ultimate catastrophic thing. And because it's always a 1% probability event, like yeah, us to close the Strait of Hormuz for any durable period of time would push crude prices, not just past 100, but past 200. It's just such a small probability that I don't think it's within the realm of even near the base case. I think more recently, after these attacks, and we're recording this on April 16, Iran just launched the attacks against Israel an unprecedented attack. I think what's fascinating is that it is both unprecedented, but I think depending on who you're speaking with, seemed like it wasn't designed to deal kind of maximum damage. So we'll parse that again a little bit more in a second, but just again, speaking about the direct impact of the oil market, so now, if Israel strikes back after this latest Iranian strike, maybe Israel targets Iranian oil facilities, and then that kind of reduces Iranian exports in some ways or maybe the US government begins to re-ratchet its own kind of sanctions enforcement against Iran. So those are the main questions in this immediate term, is essentially what's happening with Iranian crude and so far, we really haven't seen Iranian crude kind of do much over the past couple of months. It's been pretty stable in the ballpark of things.

Erik: It seems to me like the really big determinant there is going to be US participation and particularly, the degree to which the Biden administration is willing to continue unconditional support of Israel's desires. Because I think it's just very clear, because they said so, that Israel would like to make a very, very large scale retaliation against Iran for the attacks that occurred over the weekend. For the first time really, since October 7, Biden put his foot down this weekend and said no to Netanyahu, we're not going to support you in further escalating this. We don't want to get into outright war with Iran, it seems to me like, you know, the question is, okay, what happens next? Does Israel push back? Is there political lobbying, trying to get support from the United States to support a larger retaliation that does continue to escalate this? Or does Biden continue to stay on course? Do you agree that that's what's important here? If not, why not? And if you do agree, how do you see it playing out?

Rory: I think you're right. I think that Israel, and many different factions within Israel want a very strong retaliatory response. I think, again, I was saying earlier that this direct assault against Israel is itself unprecedented from Iran, and in many different quotes I've seen from various Israeli policymakers have kind of emphasized that their response also needs to be unprecedented in a way, there needs to be a similar degree of shock. But then I think, you're right, I think that virtually all governments around the world have really been pressuring that Netanyahu government not to overreact, but not even to, just not to escalate this further. So whatever the options that are being discussed, and maybe this compromises that maybe the United States does help provide support in some kind of more limited strike. But I agree that, you know, absent US support, it seems unlikely that Israel would do something dramatic. Now, the risk, of course, is that Netanyahu calls Biden's bluff and does something anyways, and kind of thinks, well, if things really blow back, you know, obviously, Washington's still going to have our back. So I think I'm worried about the degree the possibility that even with all of that in place, we still do get something further escalatory in terms of response from Israel here.

Erik: Rory, let's move on to the other geopolitical conflicts, Ukraine and Russia, obviously, being the big ones.

Rory: You know, here, this big question is, after a very long time, and obviously, we're now going on two full years of the Russia-Ukraine war. Over that period, there have been various fits and starts of presumed energy impacts from the initial assumption, back at the very beginning that forecasts that shocked the market when the IEA called that Russia was going to lose 3 million barrels a day of production, which it ended up not happening. From that moment, we really haven't seen huge disruptions emanating from Russia, it's actually been shockingly resilient, considering the variety of forces kind of arranged against it in terms of trying to maintain these flows. So Russia has been maintaining production really, really well, until the last couple of months. And at the beat, the beginning of the year even, it really picked up at mid March, Ukraine dramatically increased its attacks against Russian, particularly refineries, but broader kind of petroleum related assets from oil depots and shipments etc. So, this has been deeply unpopular in Washington, obviously, the overall US view through the entirety of this conflict. And to the point that that was the entire initial impetus behind the creation of the price cap was to maintain pressure on Moscow without actually physically removing Russian barrels in the market.

So now, there's this strong concern that Ukraine is essentially taking matters into its own hands, obviously, there has been tied up in US Congress in terms of the next Ukrainian aid package. So they feel like, you know, if you're not going to directly assist us here, we're going to have to do things on our own. And they've been essentially aiming their own drone forces at a variety of Russian refineries, which from the perspective of warfare, in particular this war, are very, very attractive targets. They're large, they're stationary, they're hard to defend. They're very explosive. And they're very important to Moscow's war effort, both in terms of direct fuel contributions to the front lines, but in addition to obviously a massive cash cow and kind of financial support for the war, in turn. So I think this has two major effects on the market. One, which is obviously since mid 2020, the world has been in varying states in refining market crises, crack spreads for both diesel and gasoline, while they're down considerably from 2020 to still remain structurally higher than they would at this time of the year in any kind of pre COVID period. So refined markets are still reasonably tight. When you begin losing upwards of, and depending on current state, it's hard to track exactly which Russian refineries are back online and have gotten bombed again. You're looking at upwards of 13-14% of Russian refinery capacity has been taken offline by these attacks. So that's a huge, you're talking hundreds of 1000s of barrels of gasoline and diesel. Russia exports about a million barrels of diesel a day in a normal year. So we've probably taken a chunk of that. And that was a middle distillate market, it was already pretty tight. And obviously, recently, Russia had actually banned the export of gasoline because of domestic shortages. So now, not only do they not probably have enough to export the measly amount of about 100,000 barrels a day of gasoline they were exporting prior, they may actually now be shifting into the position of a net gasoline importer, which again, further tightens those global seaborne barrels. So that's the refined product market.

On the other side, and obviously, most of the real way that has been felt so far has actually been in the crude market. And I think it's strange, because in some ways, the loss of refinery should actually be bearish for crude oil and bullish for cracks or for refined products. But in this, the market has actually been taking far more concerning the crude side, and I think there's a couple ways of squaring that. The most notable one is the concern that Ukraine is not going to stop here. You know, in addition to hitting these big, juicy refineries, Russia also has a bunch of very stationary crude export terminals that it could target, it has thus far not targeted those. So I think that least thus far, we haven't seen that escalation. But that risk is always there. I think that's definitely what helped push prices higher initially. The more structural thing that this could do, and the reason you have begun to see some reductions in the overall export of Russian liquids, because, you know, the other thing is that, well, let's say these refineries get knocked down, why doesn't Russia just export the crude? The challenge is that many of these refineries were kind of the end of the road for various pipelines in Russia, and you don't have infinite flexibility. Obviously, Russia has already had to considerably rejigger its crude flows, because so much had previously been going to Western Europe, and Eastern Europe. So those have already been switched. So you don't have a lot of flex in the Russian pipeline system. So a lot of those barrels are kind of getting trapped in around their production regions. So you've seen this kind of pressure to begin cutting back on crude production. And what's really interesting, I think, one of the most notable ways that you can begin to see, in my humble opinion, the realization that kind of severity of these attacks on Russia's capacity to produce crude oil is, after all of these attacks started ramping up, all of a sudden, Moscow talking with its OPEC allies, and through OPEC+, kind of offered well, actually, we've been doing these weird export cuts that no one really believes in and everyone just kind of ignores. But maybe we should transition them to production cuts instead. And we'll ramp that up over the next couple of months. But you know, to me, it seems like Russia is not the type of actor to do any of this out of a sense of altruism, or kind of camaraderie with its OPEC+ brethren, obviously, prior to this, that it had, it had actually been kind of weaseling its way with these export cuts everything else. So I think the fact that all of a sudden, out of the goodness of its own heart, decided that actually we will deepen these production cuts now, as part of this OPEC+ deal. For me, it was actually the kind of evidence or hint that Russia's capacity to produce crude was also getting hurt. Now, we're still nowhere near the initial 3 million barrels a day production loss that the IEA called for back in 2022. We're still within kind of a broader norm of Russian production. But I think you're beginning to finally start to see that pressure ramp up. Whereas, for a while, it seemed like Russia was doing exceptionally well. And I think this is the first sign that Ukraine has a capacity to actually cause more economic harm than they had been previously.

Erik: Our longtime listeners already know, Rory, that any oil market interview is not a Rory Johnston oil market interview until we've discussed the good, the bad, and the SPR. So let's talk about the Strategic Petroleum Reserve next. I have to admit that I am not extremely well informed on some of this, but I have lots of questions for you because when I saw the Biden administration announced that they had begun refilling the SPR at the maximum possible rate. Immediately, I was skeptical and I thought, okay, what's the game being played here? Because they were able to draw it down at the rate of a million barrels a day, all of a sudden, there's supposedly a technical limitation, which says the maximum rate at which it can be refilled is only 100,000 barrels a day. So I'd like to understand what the reason is for that, when I saw that the immediate thought I had is, okay, what they're doing is they're paving the way to reverse course, in other words, before the election, I bet that Biden is going to draw the SPR down again. And the only way to politically have covered to do that is if he can say retrospectively, well, but look, you know, we drew it down before and then we were refilling it as fast as we could, but it's those stinking Iranians that started this conflict that forced us to draw it down again, we're just responding to the market. Why is it, first of all, that they can only refill it at the rate of 100,000 barrels a day? And is this political? Or are there good reasons that we've taken this course?

Rory: So I would agree and disagree with certain parts of that. I mean, obviously, at this stage, we can all acknowledge that the SPR is political, that's part of its challenge, is that I wish it could be this completely separate organ, something like the Federal Reserve that could have complete independence. But no, it can only really operate on the direction of the president. And it can really only be funded by Congress. So it still is caught in this kind of politics constantly. So I think that's a never steady truth of the SPR. But I think, so what we've seen year to date, basically, the SPR bottomed out last year, and has steadily been kind of beginning to crawl higher, as DOE has, or the Department of Energy, has been trying these kinds of fixed forward contracts. And I've written a lot about this back over the past two years, essentially arguing that DOE should take advantage of a highly backwardated crude curve. And buy these barrels forward and help support kind of the forward pricing, which again, in turn, helps US producers, which looking further down the curve to kind of get and hedge their barrels. So that was the kind of argument, I think, what we have seen is that they've added essentially, call it 30 to 40 million barrels a day, depending on where your benchmark is from, in these fixed forward purchases. And over the past couple of months, they've been doing it at the pace of 3 million barrels a day a month, or roughly 100,000 barrels a day. That to my knowledge is not the peak. It's not the peak refill capacity. My presumption on that, and kind of what I understood technically was, it's probably closer to kind of 300,000, maybe 400,000 barrels a day. But it definitely isn't as large as you had the capacity to draw it down. And that makes sense to a degree. I think when you think about how the SPR was designed, it was designed to kind of build up slowly and then release all at once in a big crisis. So it makes sense that you have more drawdown capacity than refill capacity. But I do think that it probably isn't entirely correct, that that's the fastest they could, I think that's the fastest they wanted to. And I think, again, beyond the just the technical capacity, the caverns, and the SPR and the pumps everything in between, you also have the capacity of Department of Energy itself, it has never tried to refill the SPR like this, it's still trying to figure out these contracts. I wrote a lot over the past kind of 18 months about all these new contract details that they're trying out. And, you know, the solicitations for how to do this in a way that got them a good price and got them kind of some of the other policy upside they wanted, which was again, trying to lift the back of the curve. So I think they've been reasonably successful on that. And they've learned, over time, the challenge, I think, is that the comms and the communications around the SPR, I think is the weakest part of the entire administration's approach to this. And I say that because I think that over various points, they've made a bunch of unforced errors, none of which were, you know, operational and all of which were related to communications. I think the initial way that it was announced as kind of this, almost a challenge to OPEC, I think really alienated OPEC in a way that was very unproductive and made them see the SPR as this like strategic challenge, rather than I think, when it shouldn't be viewed as just an additional help. Because again, like we were talking about that, initially, part of the reason that people were concerned in 2022 was that OPEC didn't seem like it could keep up with its own production commitments. That was a perfect time to kind of add on to OPEC with the SPR. It didn't need to be adversarial. But regardless, they still did.

And I think, to this point you're making about them saying it's the fastest they can possibly do it. I think, again, that's probably overstating the case. And they've been a lot more concerned about how it all sounds, rather than I think the actual best optimal market impact of the SPR, which has always been more my concern. I think, in that in that case, they should be clearer with things, I think they always try and obfuscate some of the details to make it seem as good as possible. But in the process, I think for anyone trying to follow this one, it's difficult to follow. And I think people that are following this in more cursory manner, kind of get confused, because for instance, the Secretary of Energy had said that until they had paused their repurchases with these latest price hike, that they were going to refill the SPR entirely by the end of this year. And that is both true and really, really not true for obvious reasons. Obviously, they were not going to refill it back to the full 200 plus million barrels that they had drawn down, but rather, what the subtext there was, was that even before the SPR release in 2022, there were all of these congressionally mandated sales out of the SPR that were going to structurally draw that thing down anyways, and part of what they got out of the big release in 2022 issue was that they could basically count that all as these congressionally mandated releases. So what she was really saying when she said we're going to get back to full is, we're going to get back to the point that we would have been, if, Russia-Ukraine never happened, if the emergency drawdown never happened. And we just were drawing down this congressionally mandated sales. So I think that's a fair point to make. I think it's a technical point to make. But it's a very, very bad comms point to make. Because everyone's like, obviously, that's not true. Obviously, you're not going to put 200 million barrels in this thing by the end of the year. So you get those types of things that when you choose the optimal comm strategy, rather than the optimal policy strategy, I think that's what's especially frustrating in moments like this. And yeah, basically the main focus I would say here, is that the comms have just made everyone else's jobs much, much harder. Going forward, I believe that they probably will begin to buy back, more crude again, if the price drops back, let's say from $90 where it is right now back to let's say, you know, $80 or lower. The challenge is, is that where I was saying with all those congressionally mandated sales and how they get around all of those, this big, chunky 180 million barrels in 2022, but they don't have that money anymore. That's the problem. All that money was remitted back to Congress. Basically, the paper overhauls in the budget, you need to recapitalize the SPR account, if anyone is going to refill it much more, we're already more than halfway through all of the remaining funds in the SPR account, which just I think will further make this really challenging politically. Because, you know, congressional Republicans are going to make hay about no more SDR purchase where, I think the White House will then very rightfully be like, well, but we need more money in order to actually do that. So again, this is where, to the first point you made, that the SPR is political, I think that its weak, its biggest weakness. And I think if we want this, I think really unique strategic asset to be best leveraged, both for I think, true US strategic interest, but I think more broadly, market stability interests, you need to continue to erode that link with the political, because it's just going to constantly stymie any attempts to make this a real useful tool.

Erik: Between now and Election Day, do you think that we'll see a net build or a net draw down on the SPR?

Rory: Between right now and then, I think we will see a net build, because I think we still have forward purchases, that barrels that DOE has purchased already, that aren't set for delivery until, let's say, August. Though, and again, that was part of this whole fixed forward contract purchase idea. Now, I think what you're really asking is, will we see an SPR release, you know, some kind of reason conjured up to release from the SPR in order to lower pump prices, in order to kind of juice the political prospects of Democrats end in the fall, and I think, as a someone who truly believes, I think, in the policy, relevance and importance of the SPR, and I think, again, people that I have discussed this with, in various organs of government, there is an earnest desire to make this a more useful tool for those goals. But everyone I speak with in the market, believes that that Biden will probably tap the SPR in some kind of way. And even earlier today, you had a White House spokesperson that was asked about will the SPR be tapped or to you know, combat rising pump prices. And the spokesperson was essentially something like, oh, well, you know, all options are on the table, and we look at everything, including the SPR, which I get as a standard kind of boilerplate political response. You don't want to limit policy, optionality, et cetera, et cetera. But when your major issue with the SPR is a comms problem, and kind of managing expectations, I think that kind of wishy washy, this is not very helpful. I think the answer is no, we will not tap the SPR unless we have a calamitous development of the market between now and November, something like Iran closing the Strait of Hormuz, like that is an instance where yes, if Iran close the Strait of Hormuz, I think they should basically open the tap on the SPR, and basically never let go. But barring something of that scale, you would need something that looked like early 2022, in order to justify anything of the scale of the intervention of early 2022. And I think at this point, both legally, the President needs a bigger reason to release that level of crude from the market, although I'm sure that lawyers can figure out ways to get it done. But I think that both legally, and I think just in terms of maintaining any credibility of this tool, I don't think that they would do it. I think that you know, for me to support an SPR release again, you would need something that looks like, that you would need OPEC will have needed to completely erase that spare capacity, which as we discussed earlier, seems impossible between now and November.

I think the other thing I just want to scratch on here for a second is, that there are a lot of kind of progressive policy people that have seen the success or at least perceived success of the SPR release in 2022. And they kind of look at it like, wow, there's this amazing, our own little OPEC in a bottle. Look at all these things we can probably do with it. And I think that is a very, very concerning development outlook on the SPR. I think the important thing is, it really is an emergency reserve. It should be used in a vanishingly few degree of cases. And I think importantly, it should only really be used if OPEC itself isn't getting tapped out in some kind of way. Like the big difference here is that the SPR is inherently limited. It's inherently finite, we know exactly how many barrels are in there, we know exactly how long it can maintain a draw of a million barrels a day, which is at this point just over a year. That means that you can basically replace Oman and the global crude balance for a year. That's not a little, that's actually a big chunk of crude and I think it can do a lot of good things. But it can't go toe to toe with Saudi Arabia. So any kind of situation that you put yourself in, where again, I think this was an error for OPEC to see the SPR and the SPR release as this kind of challenge. It needs to be done in a kind of like a more collaborative way with awareness of the market conditions and what doesn't justify a release.

Erik: Rory, I want to thank you again for another terrific interview. But before I let you go, please tell our listeners what services you offer it commoditycontext.com. And the best way is to follow your work.

Rory: Thank you so much for having me. I love that conversation. So listeners can find all of my work at commoditycontext.com on Substack. I publish multiple pieces a week, including a weekly roundup called Oil Contracts Weekly. I've also recently developed an institutional advisory service if people want to reach out to me about that, if you need a fractional oil analyst in your life. And we'll also be developing some data tools along with that as well. So lots of fun stuff in the pipeline. Lots of research coming down the pipe, and I hope everyone will join me on that journey.

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