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‘There is a new focus on resilience’

ONE OF THE WORLD’S LEADING ENERGY AND COMMODITIES EXPERTS, HELIMA CROFT WEIGHS IN ON HOW THE WAR IS RESHAPING MIDDLE EAST’S ENERGY STRATEGY

PATTI DOMM

Helima Croft, RBC’s chief global commodities strategist, credits her success in part on her work experience at the US Central Intelligence Agency, where she honed her analytical skills and learned to read geopolitical events with a healthy dose of scepticism.

One of the world’s most acclaimed energy strategists, Croft took time earlier in July to speak with *KT LUXE* about the ongoing conflict with Iran, the energy market and what she expects to see in the aftermath of the war.

Energy markets have been too comfortable with the view that the war could be over quickly, she warns. Global oil supply is also “reaching the limits of the safeguards” as the conflict continues and shipping is hampered in the Strait of Hormuz and Red Sea. “I do think I’ve been more sceptical than other analysts and market participants,” said Croft. “Wars are easy to start. They’re not easy to exit. And I think that’s behind some of my concern and pessimism.”

Besides heading the commodities team, Croft leads Middle East and North Africa research at RBC Capital Markets in New York. She specialises in geopolitics. Her team of strategists cover energy, metals and cross commodity investor activity, as well as US and global policy analysis. Edited excerpts from an interview:

I know I’m asking you to look into your crystal ball, but how and when do you expect the war to end?
That is the million dollar question. The question is, are we in a full-war situation? Are we in a situation where we have periodic flare-ups of fighting, followed by temporary truces? I am very

Helima Croft on US military involvement in Venezuela and its impact on the oil market

sceptical that we're going to get a final deal that encompasses all the nuclear issues anytime soon. Remember, it took years to get Joint Comprehensive Plan of Action (JCPOA) on Iran's nuclear programme in 2015. I think it was two years when the negotiation started through the conclusion of that deal. Getting this done in several months is a Herculean task.

Add to it Strait of Hormuz control issues, and it's become exceedingly clear that the Revolutionary Guard has no intention of giving up control. That's now become more important than the nuclear programme for re-establishing regional deterrence and generating revenue for reconstruction because we just don't see an easy path to sanctions relief, given the role of Congress in implementing so many of the sanctions on Iran. The US President doesn't have the ability to waive those sanctions, and then there's a whole issue of the frozen funds. Think about the memorandum of understanding (MoU). It was supposed to allow Iran access to its billions of dollars in frozen funds, and those have not really been forthcoming to date. That's part of the reason why we have this latest flare-up. Hormuz control rights is going be a central demand of Iran, and any negotiating process. But right now, it looks like we're back to square one in terms of the war.

There was a false dawn with the MoU in mid-June that people got so optimistic about. I thought of it as a Rorschach test. Everybody saw what they wanted to see. There was not a lot of substance. It contained a wish list that could get both sides to an agreement, but it was not a roadmap for anything really actionable.

How does this continued fighting impact energy supplies? And can they weather the still restricted traffic flow that we're seeing on the Strait?

We had the International Maritime Organisation come out and say it's unsafe again for commercial shipping, and we've already seen a dramatic decline in vessels traversing the Strait since the MoU was signed and the flare-up in fighting. The real question is, how many days have we bought with the exodus of ships that we saw right after the MoU was initially signed.

We had 100 million barrels, plus leave the Strait. There had been all of this oil on ships waiting to leave that had been on the water for 100+ days. Ships did leave, so you've got over a month of additional inventory cover. But again, if we're back to square one on the Strait, it only lasts you so long, and we have (the US Strategic Petroleum Reserve at) Cushing (Oklahoma) still near operational lows, the lowest levels we've seen in decades.

We've really been able to weather the storm because of the International Energy Agency (IEA) strategic stockpile release, running global inventories down to operational floors, and China paring back imports dramatically. The question is, if we have restricted flows for another multi-month period, what does China do? Does it keep imports at these low levels? What happens with the US SPR? There's a lot of uncertainty over where we're going to go on price. Our shock absorbers have been run down. We were bailed out by China. Does China want to continue playing that role? We can't overstate the enormous role that China played in averting a serious global economic crisis.

Oil prices have repeatedly surprised investors, initially not rising as much as some expected and then falling to surprisingly low levels at other times. Brent futures were trading at nearly $120 per barrel in March and they have been rising again. Where do you see prices going under different scenarios?

If you talk to national companies in the Middle East, they will tell you that they were selling those barrels into Asia in March for about $175. So, there was a disconnect between what the paper market was showing, or what you would see on your Bloomberg screen versus the actual price for those barrels in Asia when the war started. Those barrels were fetching historic highs in March. The paper market, though, has been heavily influenced by very, very successful messaging from the White House that the war was going to be over. There was a lot of optimism bias in the market that the war was going to be quick. It wouldn't expand to neighbouring countries. You had the offsets, whether it be (Saudi Arabia's) East West pipeline operating at full throttle, getting the additional Saudi exports out through Yanbu; the (UAE exports from) Fujairah, with that bypass holding up, and the SPR releases. People looked at all of that and China's paring back and said: 'The shock absorbers worked. No problem.'

But the question is, can you really lose a billion barrels plus from the market and have no bill to pay? We are reaching the sort of limits of the safeguards in the system. I think that's going be a really telling question in the coming weeks and months, depending on how long this latest flare-up and fighting lasts.

How much time do we have before real shortages happen?

You should watch the products market right now because we've had a number of issues with refineries being struck in the Middle East. Also, if you turn your attention to another conflict, Ukraine has been battering Russia's refineries, and Russia announced products export bans.

I would be watching very, very tight markets for diesel, particularly now into Europe because of what's happening with Russia. US gasoline prices have remained high, even though crude prices fell because refiners are running at full throttle. US exports also ramped up to help avert a crisis, whether it be crude, but also product exports. The US was sending so much jet fuel into Europe because of the initial concerns about shortages. But again, that means that there's no additional refinery capacity anywhere at this point. If there's anything more in terms of refinery outages, we're going to see product pricing really hit.

We're following this Russia-Ukraine story very carefully because diesel is the lifeblood of manufacturing. When you have diesel shortages, that's a real problem.

OPEC+ is facing many challenges. What do you expect the group to do going forward and how much influence is it going to have on oil prices?

The group is going to be very, very judicious about additional supply increases. Where I think I differ from other analysts in the market is I don't think we're on the verge of an imminent market share war because the UAE has exited OPEC. In our conversations with officials in the UAE, they've been very, very clear. They are going to be very cautious about bringing additional supply to the market. They are going to continue to have dialogue with OPEC member states about production policy.

I don't see that we're going to have a sort of race to the bottom with everybody putting supply into the market. Part of the issue beyond UAE is we've had some statements from Iraqi officials, indicating that they would like higher quotas. What we would say about that is that Iraq is really constrained by midstream capacity. It has not really been able to boost exports significantly because they need new investment in midstream infrastructure and their ports. The challenge for Iraq is that they don't have the ability to massively ramp up. So they're asking for something they really can't utilise right now. I don't see Iraq looking to leave OPEC because they're not sitting on a lot of additional barrels.

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Helima Croft recently sat down with Dr Sultan Al Jaber to discuss navigating global energy markets amid geopolitical transformation

Who's driving Iran's decision making now and how secure is their leadership?

Your guess is as good as mine. What we do know is that the Revolutionary Guard leadership has made it clear that they are going to end this war with Hormuz control. And they have not been willing to make major concessions on the nuclear programme. I think part of the reason why the MoU initially was signed was because it was sort of frontloaded with things that Iran, the IRGC would like. Cash up front, the prospect of sanctions relief, no requirements in terms of curbing nuclear activities beyond saying that you're not going to have a nuclear weapon. There was not a lot of specificity in terms of enrichment levels, inspector access, and what to do with the stockpile of highly enriched uranium. It was really short on details but contained a lot of things that the IRGC would want.

It was understandable that they would sign that document, but they have been pretty consistent in terms of their nuclear negotiating posture, and now in terms of Hormuz access. And part of the reason why I think we've seen these attacks on ships in the Omani channel is they want to ensure that that is not an alternative route which is used to avoid having to coordinate with the IRGC Navy.

Once there is some type of resolution to the war, how long before oil production can go back to normal and will prices be higher or lower?

People really underestimated how long it would take to get back. We had people saying as soon as the MoU was signed, it'll all be back in weeks. We have one month post-MoU signing, and the MoU is in tatters. We have not seen a surge in production. Everybody was writing this optimistic scenario that it goes back. Again, tell me how it comes back. Certain countries will come back faster. If you're Saudi, you have the East-West pipeline, you've been able to get the exports out, not at pre-war levels, but you've been able to have a significant amount of volume make it to market. The UAE has the Fujairah bypass. We saw it was able to ramp up. But if you're Kuwait, you're landlocked at this point, so the Hormuz becoming secure is vital. For Kuwait to be able to get production back up, they've got to get tankers in to drain storage. Iraq doesn't even have tankers. So, they have to find available tankers willing to go help drain storage before they can start getting their fields back up and running. So, it's going to be an extended restart for Iraq. Timeline will matter in terms of price.

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What about your oil price outlook?

Tell me when this thing ends, how it ends, and we can talk about the price scenarios. I think that prices have been way too low post-MoU? Yes, I don't think they reflected the continued challenges for Hormuz traffic. Even if President Trump were to wake up tomorrow and say I'm really done this time, there are still going to be issues that disincentivise a significant segment of the shipping market from coming back. What does a tier one Western or Japanese shipper do as long as Iran has the ability to threaten your vessels with mines, missiles, drones or you have to pay them. I would just look at the situation with the Red Sea. You had the US sign a deal with the Houthis in May of last year, but Red Sea traffic on any given day is 40-50 per cent below pre-crisis levels. A number of companies just don't go through the Red Sea anymore. They just don't judge it secure because of the ongoing threat of attacks. They're going to be very cautious even in the easiest US standing down scenario. In an extended war scenario, it's going to be a lot of shippers saying, 'I don't have the risk appetite for this.'

What about the latest threats by the Houthis, declaring a naval blockade against Saudi Arabia?

What everyone will be watching is whether the Houthis take any physical action to stop vessels or whether rhetorical threats are enough to cause ships to turn around. A number of them already have.

After the fighting ends, I imagine you'll see countries rebuilding their oil and product reserves.

Oh, 100 per cent. What is going to be the lesson that importing countries take from this war? Which country had the ability to massively scale back imports, not have to implement rationing policies, or work from home policy? That was China. Because going into this war, China had been aggressively building its SPR, had been aggressively building emergency reserves. They exercised very prudent risk management. That enabled China to play such an important regulator role in the market. So, if you're Japan or India coming out of this crisis, you are going to want far more days of cover in terms of supply. That is the energy security imperative for consuming countries — it's build back better when it comes to your inventories. When you think about countries in the Gulf, they are also going to want to build more storage closer to Asian customers.

In terms of energy security, do you think this situation is going to spark more renewable energy construction and projects?

People are going to be focused on the energy addition coming out of this. That's beyond 'build your inventories'. You're going to be thinking about all forms of molecules. If there's a big winner geopolitically from this crisis, I think it's China. Asian importing countries are going to want more storage and need energy diversity. They'll need to think more about renewables. Which country dominates the entire value chain for renewables? It's China.

How do you think life in the Middle East changes after this conflict?

There is a new focus on resilience. What worked was the billions of dollars that Saudi Arabia invested in redundant infrastructure that could be used in a crisis. Like the decision to go forward with expanding the second Fujairah pipeline. The idea that even if it's redundant does not mean it's not necessary. I think there's more cooperation among Gulf countries coming out of this as well. The idea that they're in it together, I think, is going to be important. That's why I don't take the UAE's OPEC exit as a sign that we're going to have a market share war. In fact, I've been really struck by the fact that these countries all talk about the imperative data to work together.

You are one of the most widely followed energy and Middle East strategists in the world. How did your time with the US Central Intelligence Agency prepare you for this role and how has it helped you gain insights into the geopolitics of oil?

I do think I've been more sceptical than other analysts and market participants. People have said this is going to be easy. I think part of it is the experience of having seen all the optimism there was around Iraq, when (it was first termed by former President George W. Bush) 'mission accomplished'. But think of how long that war continued.

Wars are easy to start. They're not easy to exit. And I think that's behind some of my concern and pessimism. When this war started, I didn't see an easy exit ramp. I don't think it's like a light switch. A lot of people in the market are willing to say that this ends on the timeline the White House says it will. I guess coming from the Agency, I have more concern about getting overtaken by events.

One of the things I benefited from in my career is spending so much time in the Middle East — literally going and sitting there. These are some of the smartest people, and the most thoughtful energy leaders I've met in my life. It's been one of the great joys and privileges of my adult life to spend so much time in the Gulf and just have that opportunity to have deep dialogue with these incredibly thoughtful leaders and to hear their insights.

They call it a big intelligence failure when you essentially say that somebody else is going to see the world the same way you do. I try as much as I can to sometimes say, how would I see the world if I was sitting in the Gulf? How are they seeing the world? I think all too often, people in New York or London say everybody sees the world the same way I do.