INFO PACK

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Saudi Arabia, Russia and the Oil Price War

Turan Gafarlı

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WRITTEN BY

Turan Gafarlı

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TRT WORLD İSTANBUL

AHMET ADNAN SAYGUN STREET NO:83 34347

ULUS, BEŞİKTAŞ

İSTANBUL / TURKEY

TRT WORLD LONDON

200 GRAYS INN ROAD, WC1X 8XZ

LONDON / UNITED KINGDOM

TRT WORLD WASHINGTON D.C.

1819 L STREET NW SUITE, 700 20036

WASHINGTON DC / UNITED STATES

www.trtworld.com

researchcentre.trtworld.com

Introduction

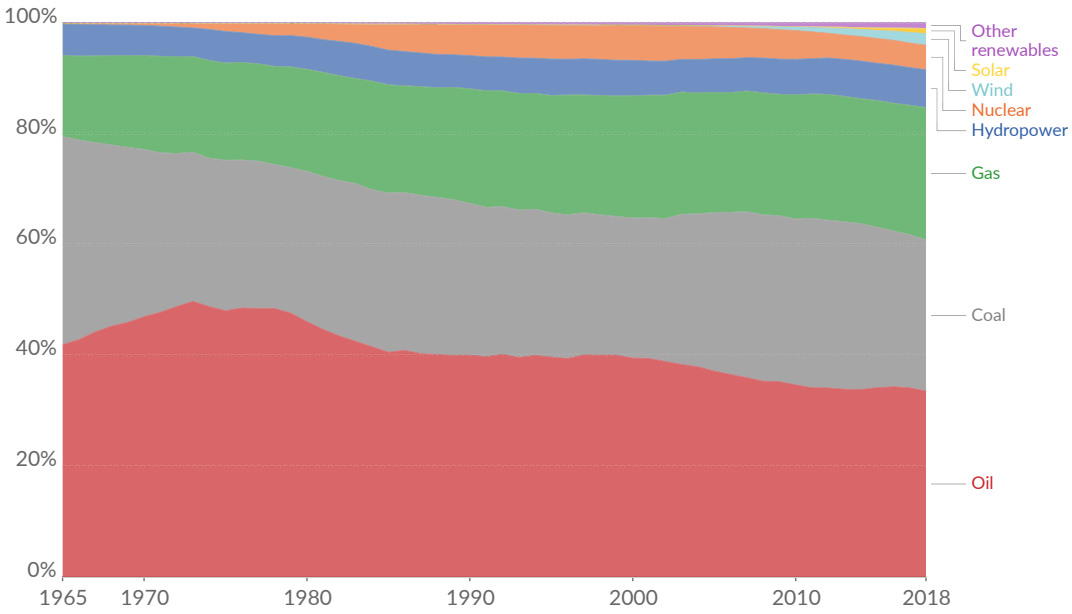
In early March 2020, Saudi Arabia launched what was in effect a price war with Russia, resulting in the collapse of global oil prices. The main reason behind was the Saudi call for a cut in oil production, in order to offset the decline in global demand caused by the coronavirus pandemic. This move was initially rejected by Russia in order to increase its own share in the global oil market and to retaliate against the US sanctions by undercutting the shale oil industry with low prices. The Saudi demand was not welcomed by major partners of the Organization of the Petroleum Exporting Countries (OPEC); Moscow walked out of the OPEC+ agreement, which was created in 2016 to secure oil production and prices.

Riyadh's answer to Moscow's rejection to cut oil production was to pump more oil into the market. This resulted in a global oil glut, where Saudi Arabia strategically hoped to convince Moscow to decrease the production by attempting to weaken the Russian economy. Because of the global economic risk and rapid decline in energy demand due to the Covid-19 pandemic, the question of global oil prices presents a challenge that can only be solved by a strong response, otherwise millions of jobs are at risk, particularly in resource-dependent economies.

The devastating effects of the coronavirus pandemic have slowed down production in Asia and reduced demand for fossil fuels. The failure of a long-standing OPEC+ agreement between two major oil producers, Saudi Arabia and Russia, has not only caused uncertainty in global oil prices, but has also led to disruptions in global stock exchanges whilst putting the US economy at risk. The new deal agreed on April 13, however, does not mean that a long-term solution for stable and satisfying global oil prices has been reached.

Figure 1: Energy consumption by source, World

Energy consumption is measured in terawatt-hours (TWh). Here an inefficiency factor has been applied for fossil fuels, meaning the shares by each energy source give a better approximation of final energy consumption.

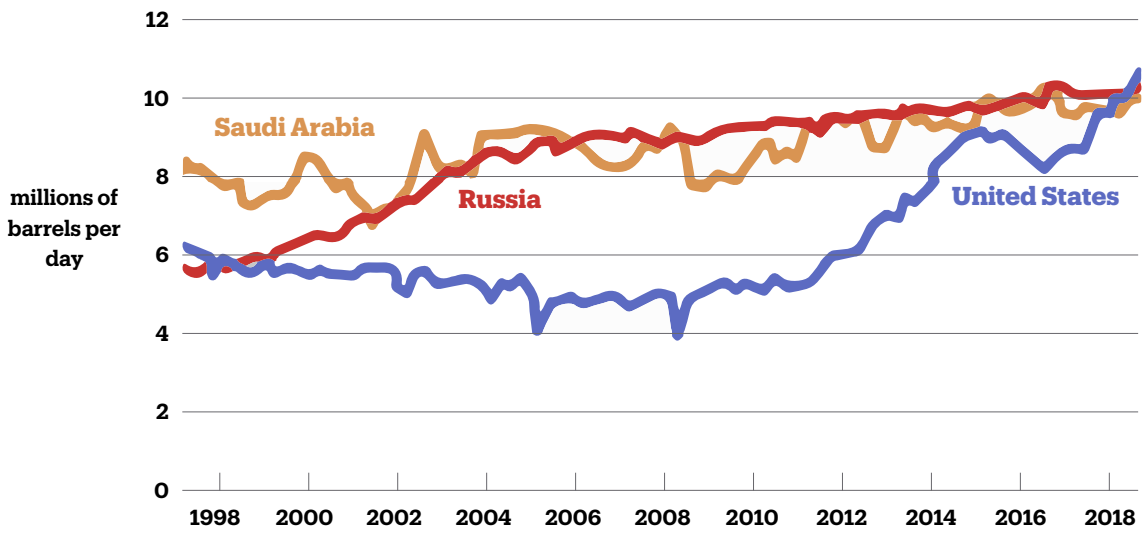


Source: BP Statistical Review of World Energy (2019)

2016 Onwards: The crisis in the context of the global oil market

Dark days for many oil-exporting countries began with the emergence of a new technology developed in the US, which made it easier to exploit shale oil. In 2014, new extraction methods allowed for US shale oil production to increase from almost 0.4 million barrels to more than 4 million barrels a day. Thus, the shale oil industry made the US a major competitor in an arena previously dominated by the OPEC cartel alongside Russia, and is projected to make the US a net exporter of oil in late 2020 or early 2021 (See Figure 2).

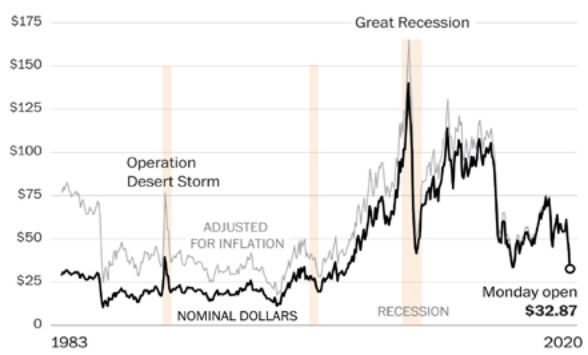
Figure 2: U.S. tops in crude oil production



Source: U.S. Energy Information Administration

The entrance of the US shale industry as a competitor created a new global oil glut with a subsequent collapse in prices from above $100 per barrel in 2014 to almost $26 in 2016. That suppression in price caused financial problems and the need for monetary reforms in oil-exporting countries such as Nigeria, Venezuela, Russia, Iraq and Saudi Arabia. As many exporter countries relied on hydrocarbon exports, various governments devalued local currencies in order to maintain the balance in the domestic market and to protect local producers. National budgets that annualised based on the high oil prices also needed to be recalculated, resulting in disruptions in the daily life of ordinary citizens as the first cuts were made to public spending.

Figure 3: Crude oil prices and sharp drop on March 9, 2020



Source: Bloomberg

Saudi Arabia, which was not pleased with the birth of a new competitor, consequently increased production, reducing oil prices to a low of $26 per barrel in 2016. The main target was the new shale oil companies in the US, which were booming and generating hundreds of new SMEs related to the shale industry. Riyadh had sufficient self-confidence in its vast foreign reserves, which could keep the Saudi economy stable even without high oil prices. However, without sufficient help from Moscow in the regulation of new production quotas against Washington, Riyadh's plan failed, and US production survived while businesses related to shale oil got stronger. The Chinese market became the only salvation for Saudi Arabia and Russia, as Beijing was in desperate need of the low-priced crude to sustain its declining economy in 2015 and 2016. The reliance on Chinese demand may have now backfired for Riyadh and Moscow as China made exporters rely more heavily on Asian customers, resulting in a serious blow during the Covid-19 pandemic.

Table 1: **The 10 largest oil[1] producers and share of total world oil production[2] in 2019[3]**

Country	Million barrels per day	Share of world total
United States	19.51	19%
Saudi Arabia	11.81	12%
Russia	11.49	11%
Canada	5.50	5%
China	4.89	5%
Iraq	4.74	5%
United Arab Emirates	4.01	4%
Brazil	3.67	4%
Iran	3.19	3%
Kuwait	2.94	3%
Total top 10	**71.75**	**71%**
World total	**100.63**	

[1] Includes crude oil as well as all other petroleum liquids and biofuels.

[2] Production includes domestic production of crude oil, all other petroleum liquids, biofuels and refinery processing gain.

[3] Most recent year for which data are available when this FAQ was updated.

Source: Trading Economics

As a result of the recession in the oil exporter economies in 2016, an agreement was reached between Russia and Saudi Arabia that same year, which informally brought OPEC and non-OPEC actors together – creating OPEC+. This new formation agreed on cutting oil production by 2.1 million barrels per day by 2020. Both powers knew that no matter how big exports would be, neither of them was strong enough to dictate oil prices alone. Therefore, OPEC+ was a product of technical necessity, rather than everlasting cooperation. Nevertheless, Riyadh's production cuts could not change the fate of the industry and bring back the glory days of prices of over $100. In contrast, US shale oil not only survived, but fulfilled the production gap that was artificially created by OPEC+ to keep prices high. As a result, the US became the leading producer and consumer of oil products, which gave Washington substantive power in the industry. However, predictions for the US to become a net exporter in the future still does not mean that it will be immune from rapid drops in oil prices.

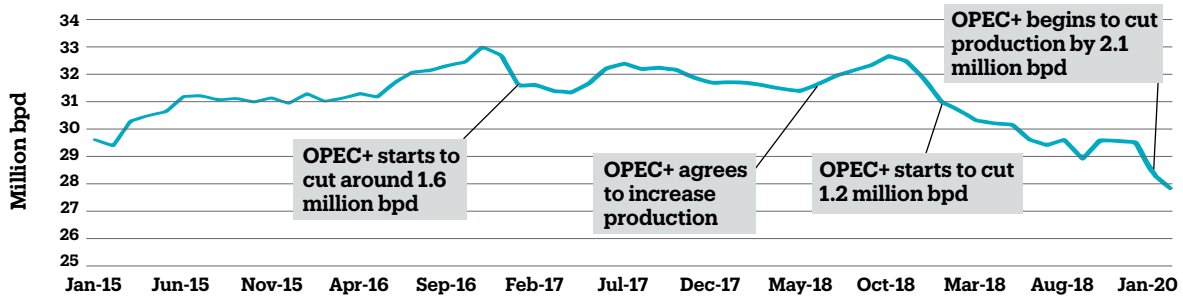
Despite the increasing influence of the US over the market, which was also triggered by relatively stable oil prices and recovery from the global financial crisis, Saudi and Russian cooperation continued through the OPEC+ platform. The alliance fulfilled the demands of developing countries, especially the Chinese needs for crude oil to sustain economic growth. However, the coronavirus pandemic has hit the oil markets hard due to decreasing the demand for oil from Asian markets. Oil prices were already in decline at the start of 2020. Confronting the grim situation, Saudi Arabia and Russia were left with a choice: either to continue the cooperation or break it and return to a state of competition.

How did we arrive at the present situation?

The coronavirus pandemic is asserted to be the primary driver of the current oil price war. Global transportation, factory production, and output, alongside daily oil consumption, fell rapidly, which led to the sharp plunge in demand for oil. The free fall of oil prices, along with the major consumption drop in Chinese markets, led to an OPEC summit held in Vienna, on March 5, 2020. OPEC's initial decision was to cut an extra 1.5 million barrels per day through the second quarter of the year in order to keep prices stable and see through the decreased global demand. However, OPEC's call on Russia and other non-OPEC members to curb oil exports faltered as Russia rejected cutting its production. Moscow's rejection resulted in the un-official end of the OPEC+ partnership that was created in 2016, with the decision triggering a further 10% decline in oil prices.

Figure 4: OPEC oil production and supply adjustments

OPEC and its allies have adjusted production in order to balance the oil market since January 2017



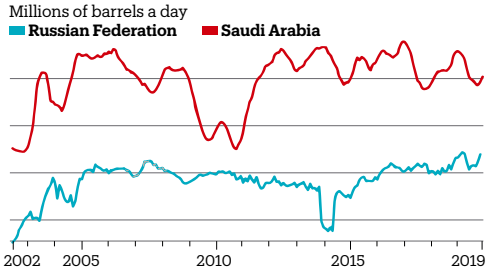
NOTE: OPEC+ agreed to cut 1.7 million bpd in December 2019. The figure 2.1 million bpd includes voluntary reductions

Source: Refinitiv and OPEC

In February 2020, China cut oil imports by 20%. As Saudi Arabia is one of the main suppliers of oil to China, Riyadh decided to increase prices to consolidate its lost profit margin by cutting production further. And when Riyadh could not convince Moscow to make the same decision, it started an unofficial oil price war. As the OPEC+ partners decided to go their respective ways, both Russia and Saudi Arabia elected to flood the market with oil in April, which dragged oil prices down even further. Riyadh's decision to tank the market with discounted oil resulted in the worst days vis-à-vis prices of both WTI and Brent oil since 1991, with the development expected to cause an all-time low if the coronavirus pandemic and price war continue.

The foreign exchange reserve estimates of Saudi Arabia and Russia - $490bn and $440bn respectively – make it clear that both are prepared for a protracted confrontation. However, the numbers are also clear as to who has a greater need for higher oil prices. Since the 2014-2015 oil price crisis, major export countries have not been able to fundamentally diversify their energy consumption patterns or their reliance on crude oil exports. For Saudi Arabia to balance its budget, the price of oil needs to be around $82/barrel, while Russia can withstand $42/barrel according to the IMF. While the current prices are nowhere near the figures needed, Saudi Arabia's gamble is understandable, the basis of its aggressive moves being to push Russia to return to the negotiating table and figure out a way raise the price of oil.

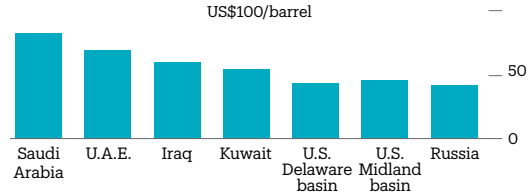
Figure 5: Crude oil exports of Russia and Saudi Arabia *(millions b/d)*



Source: JODI Oil

Figure 6: Breaking point of price per barrel for main oil producers

The level at which U.S. oil producers break even on their oil production is lower than that at which most exporters balance their budgets



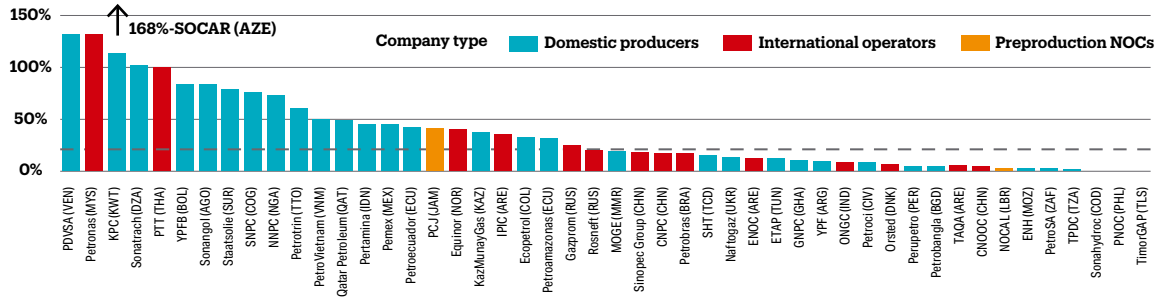
Source: IMF, BTU Analytics

Why did Russia reject the original deal with OPEC?

There are different explanations behind Russia's motivations not to agree with OPEC on cutting oil production further. Firstly, US sanctions on Moscow's strongest asset, Rosneft, the major Russian oil company, has shaken confidence in the Russian stock market and foreign customers of the company have been reluctant to invest. Rosneft is accused of helping the Maduro government in Venezuela, which is under heavy economic and political pressure from Washington. Billions of dollars of Russian investment helped to keep the Venezuelan economy going. However, Rosneft made a surprise statement on March 28, declaring departure from the Venezuelan market. Analysts understood this move as Rosneft's attempt to escape US-sanctions. Under normal conditions, a giant such as Rosneft would stand firmly against Washington's threats. However, as the Chinese customers of Russia steadfastly stated their unwillingness to purchase oil from the sanctioned company, Moscow had no other choice. Rosneft's exodus from Caracas does not necessarily mean Russia's withdrawal from Venezuela's oil market. To extract itself from the Venezuela situation, Rosneft sold its assets to a company named Roszarubzhneft (Russia Foreign Oil), a wholly state-owned enterprise whose relationship to Rosneft is not totally clear. The possibility of sham transactions of Russian assets was also noted in Washington since Venezuelan oil shares previously owned by Rosneft will still be in the hands of Russians. Therefore, sanctions relief for Rosneft is not yet a done deal. The uncertainty over Rosneft and its business with China due to US sanctions may result in Russia rejecting an increase in prices, since Moscow may favour low prices to hit shale oil companies in the US as retaliation. SMEs related to shale oil in the U.S. have already lost almost 45% of their value. However, these developments may backfire as bigger US companies such as ExxonMobil or Chevron could take over these cheaper assets and become even stronger after the crisis by creating a greater domination over SMEs in the shale oil business.

Figure 7: The risk of oil dependence in detail of national oil companies

At the peak of the oil price boom, there were at least 25 "NOC-dependent" countries-where the national oil company collected funds equivalent to 20 percent or more of government revenues.
(National oil companies total revenues as percentage of general government revenues, 2013)



Note: Data labels in the chart use International Organization for Standardization (ISO) country codes. NOC = national oil company

Source: Heller and Mihlyi, 2019 *Massive and Misunderstood Data-Driven Insights into National Oil Companies.* **NRGI**

The second motivation behind Russia's all-in decision in the price war may be related to its global ambitions. As the US gained significant influence in oil exploitation and the Saudis have become more rivals than partners, Russia may be thinking about the prospects of increasing its dominance in the global oil arena. Russian companies can already make a profit with low prices, and the Russian Rouble has seen worse times as recently as 2015. Russia's foreign currency reserves and Rosneft - under no sanction pressure - can safely sustain Moscow for a few years. Indeed, the Russian finance ministry stated Moscow could bear an oil price of $25-30/barrel for the next 10 years. However, some financial analysts speculate that crude may see way lower prices, even as low as $10/barrel – at least in the short-term - if an agreement is not forthcoming.

The current oil price has the potential to provide a path for Russia to regain market share, seizing the moment during the on-going Covid-19 pandemic. However, shares of both Rosneft and Saudi's Aramco have fallen since the price war. Some analysts argue that the price war is a war of egos rather than calculated economic confrontation. While thinking of global dominance, both countries may simply lose their current shares in the industry. Times have changed. China is not there to buy out cheap oil as it did in 2015 and both Beijing and New Delhi have announced that their oil reserves are already full and sufficient particularly considering the reduced industrial activity due to the pandemic.

The April 13th agreement and the future of OPEC+

Prior to the April 13th agreement between Saudi Arabia and Russia, there were predictions that oil prices could sink as low as $10/barrel if OPEC and Russia did not agree on a deal. This would induce questions concerning extraction costs and whether or not it is worth continuing excess production (See Table 2). From the US perspective, if oil were to drop to that level, there is a major risk that US production could be halved from 13 million b/d to 7 million b/d, which would mean the further bankruptcy of small-mid size shale oil companies.

Table 2: **Cost of Oil Production in the World -** *2019, March*

Country	Production cost (bbl)	Total cost (bbl)*
United Kingdom	$17.36	$44.33
Brazil	$9.45	$34.99
Nigeria	$8.81	$28.99
Venezuela	$7.94	$27.62
Canada	$11.56	$26.64
U.S. shale	$5.85	$23.35
Norway	$4.24	$21.31
U.S. non-shale	$5.15	$20.99
Indonesia	$6.87	$19.71

Source: Trading Economics

The US shale industry is already facing bankruptcies, and the fear of a shutdown in production could easily end up in millions of people becoming unemployed. With the upcoming US elections in November, President Donald Trump cannot afford to have more jobs lost, especially in states like Texas and North Dakota, which rely on the oil business. Hence, President Trump has also been under pressure from energy lobbyists. The oil producers urged the White House to take strict measures, such as threatening Saudi Arabia with military aid cuts and tariffs on imports. On the Russian side, lobbyists demanded a new wave of sanctions against Russia and its oil industry.

In its own terms, Saudi Arabia wanted a rapid deal that covers all global producers, even if it can only via the pressure of historically low oil prices. For Riyadh, the new cuts must be comprehensive and not limited to OPEC+. In this case, G20 members were also asked by Riyadh and Moscow to decrease its own production which in the final deal the US, Canada and Brazil only supported the deal rather than pledging a commitment to cut. On the other side, Russia also demanded the involvement of all global exporters in the new deal. There was a possibility of Russian lobbying revoking US sanctions on Rosneft that would secure company's future in Asian markets and lift of the pressure on by Washington because of the Maduro affair, in return of the acceptance of a new deal. In any case, the global deal is a matter that needs to be resolved in the G20 in order for it to be accepted by all exporters.

On April 9, preliminary talks on a new deal were held. April 10 witnessed another development: US and G20 support for the cuts declared by OPEC and Russia. However, Latin America's second biggest economy, Mexico, resisted to the new deal arguing that the process which required serious cuts from each producer was not fair and the country cannot be compared to energy giants in Arabian Peninsula or Eurasia. President Trump once again showed his commitment to backing the large cuts, even agreeing on helping Mexico in its production cut process. In the end, Mexico agreed to cut 100,000 b/d instead of 400,000 b/d.

The oil producers initially accepted a cut of 10 million b/d following US pressure. However, the final deal agreed upon on April 13 showed the decrease in the total output - because of the change in Mexico's terms - to be 9.7m b/d, equivalent to almost 10% of global supply. According to the deal, the cuts will last and continue with lower reductions until April 2022, which is the predicted date for normalisation in demand. Riyadh and Moscow, the two biggest producers in the deal, agreed to cut 5 million b/d, while other OPEC+ members committed to cut the other 4.7 million b/d. The Russian Minister of Energy also praised efforts made by the G20, pointing out that huge moves in production like that are almost impossible without global support. While the deal for Russian President Vladimir Putin represents a positive step in its dealings with the White House, it can also be seen as good signal for Russian economy. On the other hand, Riyadh also got what it wanted by successfully getting a global cut in oil production. President Trump also praised the deal while congratulating both Russia and Saudi Arabia for reaching a deal, thereby saving US jobs in an election year.

Despite the deal being praised in the US as a diplomatic victory and even led some analysts to claim President Trump as the new de-facto leader of OPEC, the move does not necessarily mean an immediate fix of the situation. Some analysts argue that the deal will only delay a notable supply and demand imbalance, and prices are not likely to go up rapidly. The deal can also be considered as ceasefire rather than a permanent agreement. Furthermore, the cuts can be damaging in the long run where massive unemployment, the shutdown of oilfields, and capital spending reductions by major energy companies could be a reality in the upcoming months. However, the coordination between all major suppliers and producers can be seen as a positive move for both the market and the energy sector, since cooperation is the only way to prevent the free-fall in prices. In any case, Asian markets, particularly China, can be seen as the price war's biggest winners as it has allowed them to fill their reserves with cheap oil.

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