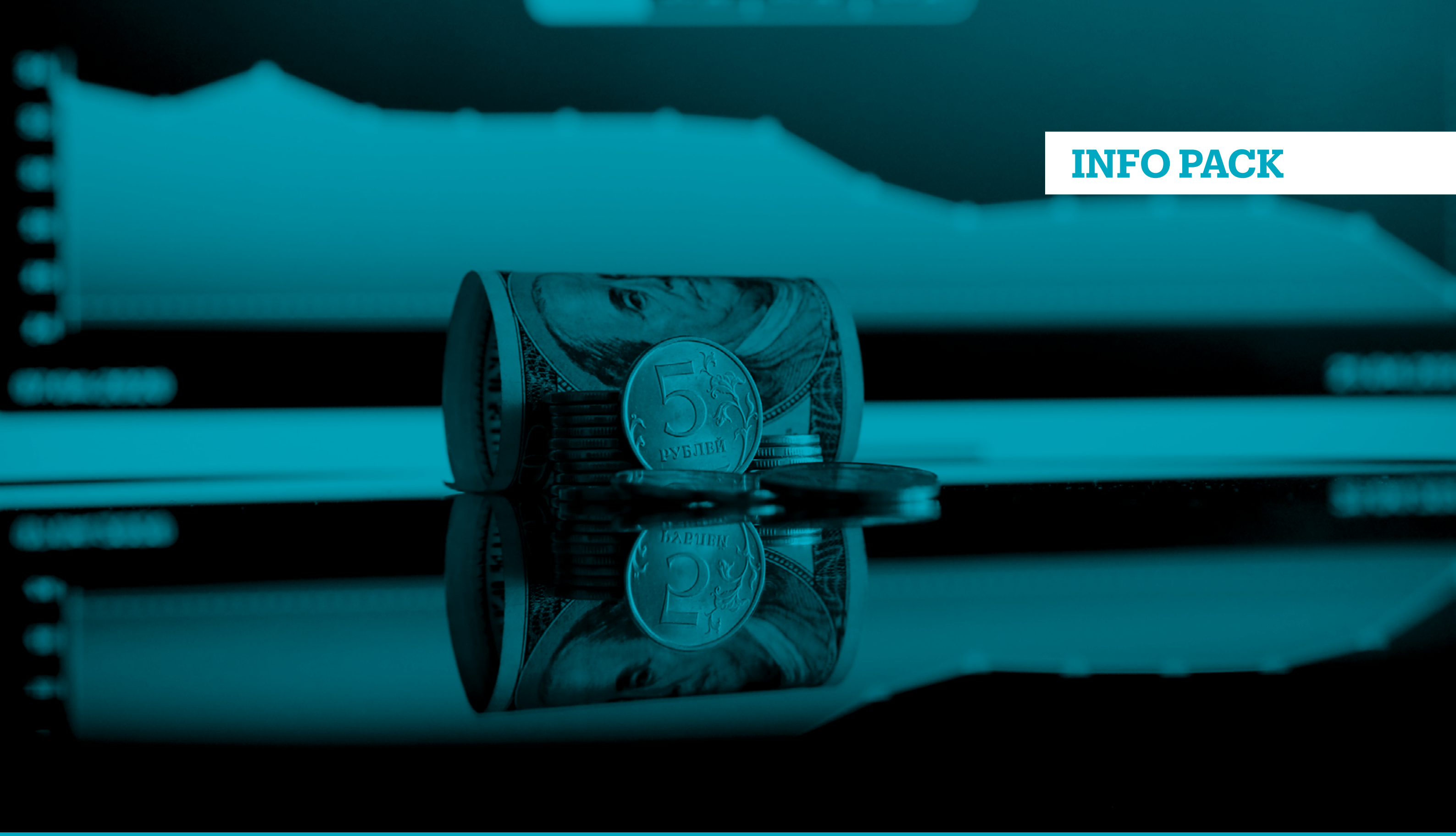

INFO PACK

The 2020 Oil Price War: Winners and Losers

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Introduction

In early March 2020, the Covid-19 pandemic had not yet revealed the extent of all its consequences on the global economy. Daily life in many countries was continuing even if there were some disruptions in others. Oil prices had become unstable since January 2020, and global demand started to decrease even before the declaration of a pandemic by the World Health Organisation (WHO).

In such circumstances, Saudi Arabia and Russia started an oil price war, which caused the collapse of the OPEC+ alliance. While Riyadh demanded significant cuts in oil production, Russia rejected the offer to join the cuts and pumped more oil into the market. The price war, combined with the devastating effects of the pandemic on the energy market, resulted in a considerable deficit between demand and supply. In April, OPEC members and Russia agreed on worldwide oil production cuts to stabilise the market. However, it did not prevent oil prices from going below zero in the futures market, prompting state and private actors to question the outlook of oil production.

This info pack examines the 'oil Armageddon' that took place in the first quarter of 2020. It examines the different players, and takes a closer look at the winners and losers of current policies, in the context of a global negative economic environment.

(Tayfun Coşkun - Anadolu Agency)

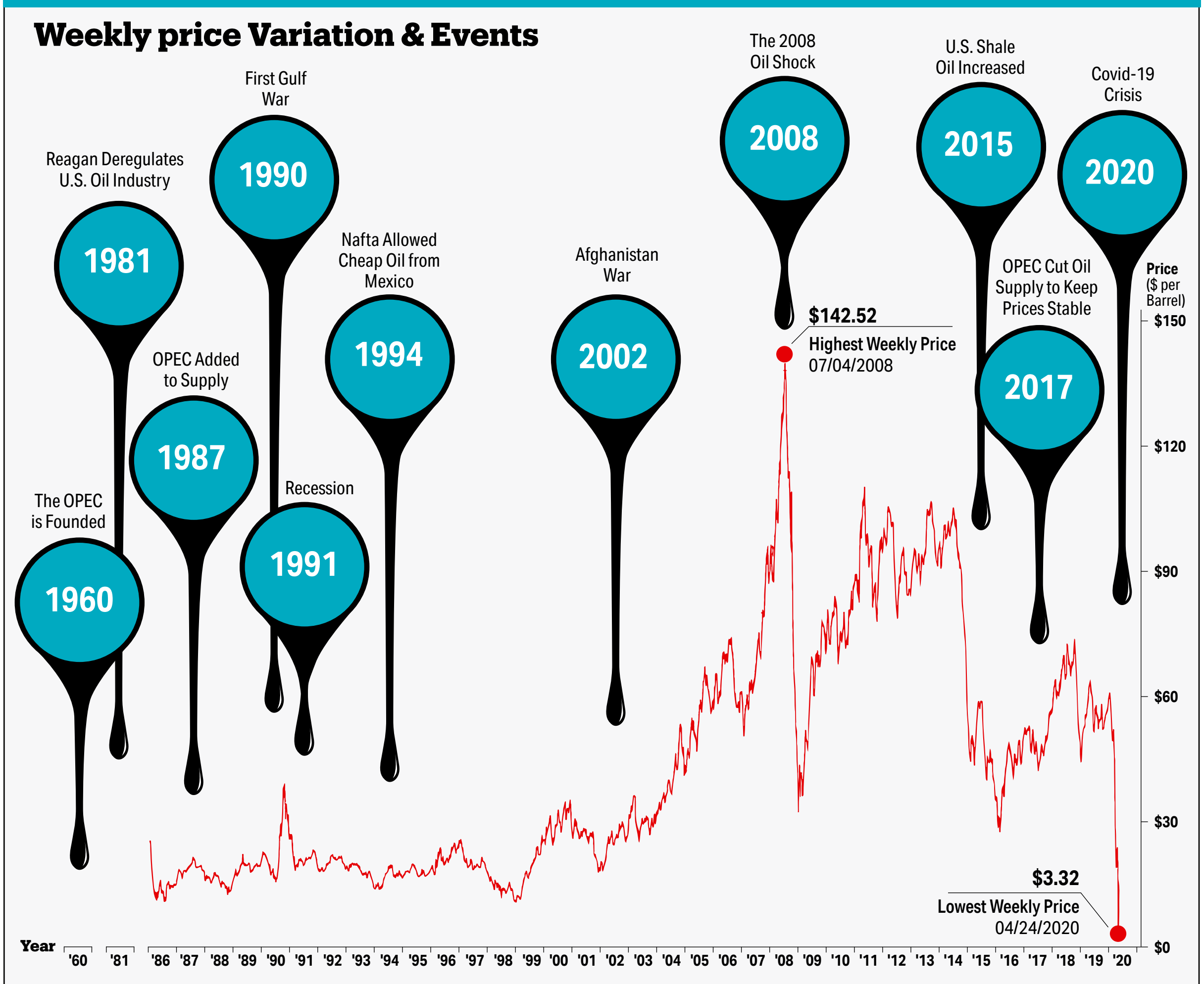
What happened?

The oil price war increased output to record levels. While prices remained low, demand was also minimised by the coronavirus pandemic. In April, oil prices became negative in the futures market for the first time since January 2016t. 20 April 2020 will be remembered as Black Monday, as it is the day when the West Texas Intermediate (WTI) crude oil hit -40 USD.

The negative price for an oil barrel rang alarm bells in the industry and was due to a few significant reasons. The first reason was decay in global demand during April 2020, seeing a fall of 29 million barrels p/d. Almost a third of the total global production was left in the storages and not consumed. The situation triggered panic in the markets. Some producers and traders were left with a product that was more expensive to store than to sell. Therefore, oil, the power behind economic development, became a product that one would pay money to unload to reduce storage fees.

Global oil consumption was reduced as the global transport sector suffered heavily because of the Covid-19 pandemic. Oil exporter countries, primarily Saudi Arabia, are currently dealing with problems in balancing their budget because of lower prices than expected. They continue to suffer from the "Dutch disease,"[1]

Timeline of Crude Oil Price Changes (1986-2020)



Source: howmuch.net

1 Dutch disease refers to the imbalance in a country's economics where a single sector (especially natural resources) is developed rapidly and decline in other parts of production increased. The term first used by the Economist in 1977 about the Netherlands where manufacturing declined after the development of Groningen natural gas field.

which has not allowed them to relieve investors. The anticipation of higher oil prices to continue investing in infrastructure projects and social subsidies can be disastrous for oil-exporting economies since analysts are not predicting prices to increase as it did in the previous "golden years" of the energy market.

Russia was another leading actor in the oil price war. It aimed to exploit this new price reality to a maximum. The country has more stable financial structures compared to its rivals in the Middle East because of its non-energy-related industrial output and cheaper crude oil production. Moscow also seeks to increase its power and influence in the Middle East amidst the oil crisis and expects the US shale oil companies to become bankrupt during this period of price instability.

Oil production in the US is not centralised as it is in the Middle East and former Soviet states. The US oil industry consists of hundreds of companies of various sizes. These firms compete with each other as well as with the rest of the world. The new realities of oil consumption and prices will leave no choice other than mergers between companies, buyouts of small companies by huge conglomerates, and bankruptcies because of the expensive cost of doing business. On the bright side, the survivors can be long-time winners and export more oil to compete against the Middle East directly.

The oil price war with its winners and losers can redesign geopolitics and change the way of thinking about energy. Historically, focus on the Middle East increased after the Second World War, as oil became the primary energy resource. The 21st century made the US the most prominent oil producer, thanks to shale technology. Therefore, there is a possibility that the Covid-19 pandemic will bring a new balance to the energy markets.

Winners

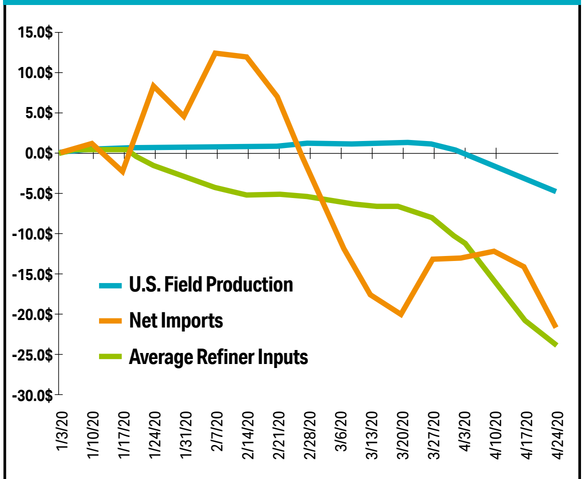
Storage facilities and oil traders:

It is difficult to declare a sole winner after the devastating outcomes of the economic crisis that came with the pandemic. As a result, it is preferable to leave calculations for the post-pandemic period. However, in the current climate, both onshore and offshore storage owners can be considered as the biggest winners of the oil price war. Given the over-supply, storage facilities have become strategic assets. Indeed, storage costs are surging in both onshore and offshore facilities. While the global storage input has become almost full and chartering tankers are waiting to continue to operate and distribute the stored oil. By way of example, the cost of monthly leasing of 100,000 barrels crude oil storage in Louisiana Offshore Oil Port (LOOP) was approximately 7000 USD before 20 April and has increased to 55,000 USD afterwards.

Oil traders are also another group that benefited significantly from the situation. They secured both onshore and offshore storage facilities to profit from future sales. The price difference between crude oil bought now and delivered later will bring vast short-term profits. Oil traders also triggered an income increase for tanker owners who currently profit from an oversupply of crude and competition in transport bookings. LOOP storage futures value increased by over 500% due to the crude oil storage shortage during April and costs roughly 55 cents p/b. It is also important to remember the pre-pandemic profits of tanker owners. The latter were benefitting from the US sanctions against Chinese Costco, one of the biggest tanker fleet companies in the world.

According to the statement made by the International Energy Agency (IEA), the decision to cut made by OPEC+ and G20 could not succeed in eliminating oversupply, and this will test the limits of storage capacities. Logistics are already suffering from oversupply, and decreasing demand is making the situation difficult for the sector, which is desperate to find physical space to store oil.

When demand contracts faster than supply



Source: Energy Information Administration

China: The primary winner of the oil price war seems to be China. The country is a global leader of energy imports. Experts say that roughly a 0.5% decrease in oil imports to GDP is equal to an increase of 0.25% in output. Thus, China is a clear example of how lower prices benefited oil importer countries while devastating oil exporters.

China saved almost 2.1 billion USD annually with every $1 fall in the oil prices during the oil market collapse in 2014-2016. On an optimistic note for China, it may be said that they continue to save millions of dollars every day because of the low prices. Furthermore, lower prices can attract consumption and jumpstart the economy. Reduced oil consumption may also help boost economic activity and production.

The Belt and Road Initiative (BRI) is a major Chinese initiative, which aims to enhance China's position as a global trade powerhouse. The BRI controls almost 200 billion USD worth of investments for infrastructure projects in the countries participating in the initiative. Even before the Covid-19 pandemic, the financing of the project was getting problematic since the International Monetary Fund's global economic growth prediction was not auspicious. The creation of new infrastructure requires cash supply from China, which is problematic in the current circumstances. However, without infrastructure investments, the BRI would fail to achieve the goal of making China a new centre for global trade. Therefore, in order to keep the momentum for BRI, Beijing must continue to supply its partners with credits.

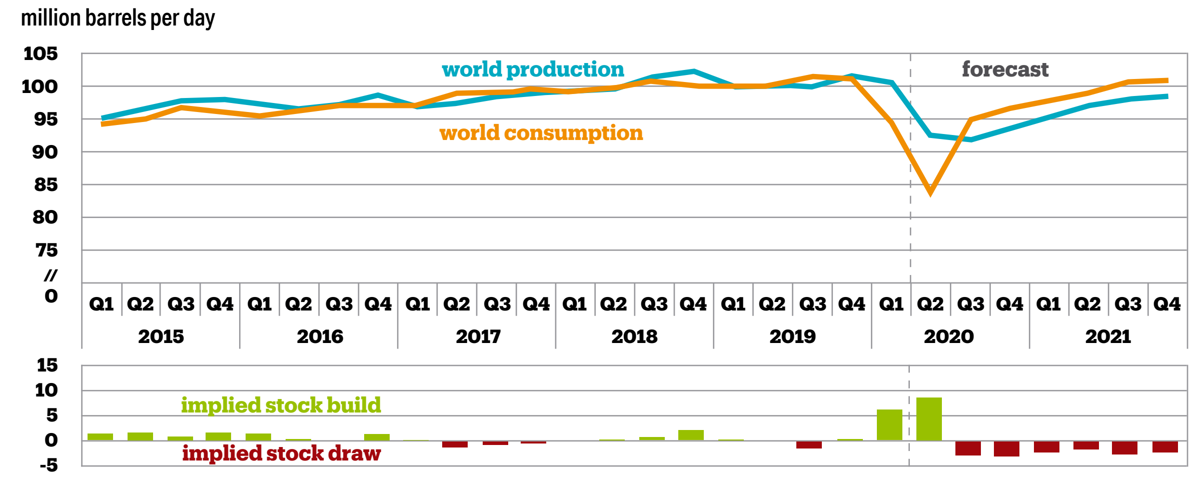
As a positive outcome of the oil price war, China will be ready to continue its investments with a smaller budget deficit in light of the decrease in oil product imports.

Chinese challenges: However, China is heavily relying on external factors and global recovery to speed up opening in its economy. Currently, China supplies vital components to tech and industrial companies in the developed economies, such as the US, Japan, South Korea, and the EU. The country generates almost 20% of global trade in manufacturing intermediate products. To compare, it was just 4% in 2002. Therefore, as lockdowns in major economies continue, demand for Chinese intermediate products decrease.

Moreover, there are critical sectors in China that are dependent on the local market, more so than exporting overseas, that may also be affected by low prices. For example, local oil producers are continuing to suffer from low prices, which forces them to focus the local market and to increase the energy security of the country.

It is essential to mention that the slowdown in the Chinese economy is not a new phenomenon that came with the pandemic. There are a few challenges such as a decrease in labour productivity, the fragility of the financial sector, and the unpredictable flow of capital that need to be resolved before fully profiting from the low oil prices. Some analyses show that a huge leap forward from the Chinese economy is less likely than moderate growth. Other analysts contend that China's recession is the new normal.

World liquid fuels production and consumption balance



Source: Short-Term Energy Outlook, June 2020

Other winners: The developing countries of the world and net oil product importers are benefitting from decreasing oil prices. In the Americas, Peru profited from low prices as the country imported almost 5.6 billion USD worth of oil products in 2019. India is another primary beneficiary of the price war since the country was another big consumer of energy. Modi's government is under constant pressure domestically. Economic growth has also slowed down in India recently. In the meantime, the country witnessed the most significant banking failure in India's modern history. Therefore, low prices helped Modi with his populist fuel prices policy and diverted eyes from other challenges.

In Asia, Japan is another country with significant financial problems that benefited from the oil price war. The country is poor on natural resources and used this chance to decrease fuel prices and help communities save businesses. However, combining the issuance of new banknotes and lower fuel prices put further pressure on the yen. It also makes it challenging for the Japanese government to reach calculated inflation targets. In Europe, Germany and France are countries that have profited from the decreasing prices of fuel. Considering these countries are major energy importers from Russia, one may say that the lower prices politically strengthened the hands of Berlin and Paris since they are also decreasing their budget deficits.

Turkey, as a significant energy importer from most of its neighbours, has also benefitted from the low fuel prices. It helped the Turkish economy remain stable during the pandemic, where production decreased while daily energy consumption of citizens increased. Turkey did not resort to full weeklong lockdowns as Italy did. Thus, its fuel businesses did not suffer as much as Europeans. The lower energy prices also helped balance and decrease the Turkish budget deficit.

Losers

Almost all oil exporters suffered high political, economic, and industrial losses during the oil price war. Experts mainly focus on the three players of the global oil price war: Saudi Arabia, Russia, and the US shale oil industry to calculate the loss.

Saudi Arabia: Saudi Arabia has the most fragile political and economic state of affairs among the three leading players. The Kingdom is over-dependent on oil revenues, which represent 90% of its export income. Furthermore, Saudi Arabia's currency is pegged to the US dollar, and thus its value cannot be devaluated to compensate for the losses. This state of affairs gives Riyadh less flexibility in the competition with Russia's free-floating currency policy. Even though barrel production only costs 3 USD for Riyadh, the price should be around 80 USD for fiscal stability. Since 2014, oil prices were only above 80 USD for a short time – in 2018.

The Saudi authorities have used their vast foreign reserves swiftly to balance the budget in the past six years. However, reserves fell by almost 24 billion USD in March 2020, and the country recorded a budget deficit of 9 billion USD for the first quarter. If we assume the spending of the foreign reserves continues at this pace, which is the fastest rate in 20 years, the Kingdom will deplete 500 billion USD in just two years. Revenues are down almost 22% and Aramco's profit for the quarter fell by 25%, with shares becoming almost 11% below the December 2019 prices during the price war. Currently, the company is slowly gaining its value back as crude prices increase.

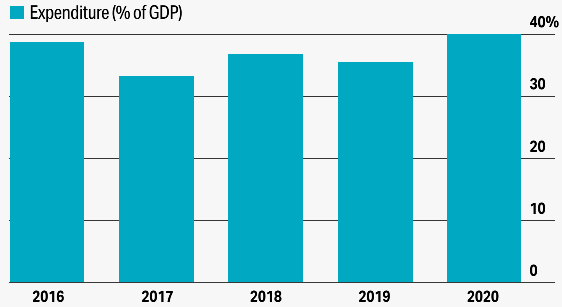
Transport distance to the customers is also critical. Russia is located close to Europe and owns a fast and robust distribution network. Therefore, it only costs 4 USD p/b to transport Russian oil to Europe. On the other hand, Saudi Arabia is selling oil to Europe at $25-28 per barrel. This state of affairs represents another substantial hurdle for Riyadh. Moreover, Moscow can finance its deficit for at least another five years with current prices and can use its significant currency reserves. Conversely, Riyadh's fiscal deficit is almost equal to 15% of its GDP. Currently, an average of 35 USD for crude oil allows Russia to sell at breaking point levels. In contrast, with a similar selling price, the Saudis will sell with a loss.

Additionally, the Saudi royal regime is under threat. In contrast to Russian President Vladimir Putin, Saudi Arabia's Crown Prince Mohammed bin Salman (MBS) is facing severe political challenges. Since the beginning of his de facto control, MBS has persecuted several royal family members. He also ventured into several foreign wars. His reform program, also known as Vision 2030, relies on foreign investments and tourism. However, the current environment is strained by a global pandemic and an oil crisis. Hence, all investments are under question, and the future of tourism is also not bright.

Falling oil prices would probably force the Crown Prince to rethink his foreign policy. Since MBS' ascension to power in 2015, the Kingdom has been involved in several conflicts. These include Yemen, Libya, along with the cold war against Qatar and Iran. The latest economic clash with Russia shows how Saudi's hand is limited on the global scale since the outcome of the oil price war was counterproductive for the Kingdom. Experts have estimated a 100 billion USD cost of the Yemen War on Saudi's budget. As this was calculated two years ago, with average spending of 5-6 billion USD per month, the total can be calculated as 200 billion USD. Low oil prices mean a higher budget deficit for the Saudis, and the increasing cost of wars will undermine their positions further. Therefore, if the present situation persists, the royal family may demand cuts in the "unlimited" budget available to the Crown Prince, including his very costly foreign adventures.

Spending in Question

Saudi Arabia might have to resort to austerity to cope with lower oil prices



*2019-2020 data are estimates

Source: International Monetray Fund

Russia: Russia is in a more advantageous position compared to Saudi Arabia after the oil price war. First, it requires only 40 USD p/b price to balance its budget compared to 82 USD of the Kingdom. The OPEC++ agreement on production cuts increased prices and helped refill the Russian currency reserves, reaching almost 400 billion USD. Therefore, in the current status quo, Russia is relatively safe for the next ten years, even with the minimum price of 25 USD.

Secondly, Russia has a flexible exchange rate. Flexibility to devaluate the rouble provides an economic advantage. Furthermore, Russia is gaining an extra 70 billion roubles for each 1 rouble decline against the USD, because the expenses for oil drilling is in roubles, whereas oil income is in USD.

Thirdly, compared to Saudi Arabia, Russia is less dependent on hydrocarbon exports, which represent less than two-thirds of total Russian exports. Diverse mineral exports, such as natural gas, coal, diamonds, and uranium deposits, continue to support the economy. Its advanced heavy industry decreases the currency spending for industrial imports, and the world's second-largest armament export entity belongs to the Russians.

Furthermore, there are less political risks for Russia since stability is valued more than economic growth. While President Putin's popularity is in decline, he proposed some constitutional changes to secure his leadership in the future. Apart from opposition members, the general Russian public seems to be in favour of these changes. In Sum, even if Russia also suffers from the oil war, it is still in a better position than the Saudis.

Nevertheless, some Russian experts claim that the country has lost some lucrative markets, which are not easy to regain. Others argue that the OPEC+ deal for further cuts is one of the most significant losses in Russian history since the Saudis have the potential to steal Russia's customers with their low prices. Russia owns vast fields in the Urals and other geographically problematic places, which would make oil shipment logistically more expensive and complicated. This situation could lead to investment cuts in the mentioned fields and result in massive unemployment.

Similar to the Saudis, Russia also fights proxy wars, mainly in Syria and Libya. Russia spends almost 4 million USD a day in Syria, which is almost unsustainable in the current economic climate. Moscow intends to be a permanent force in the Middle East and especially in the Eastern Mediterranean. The oil price war would limit its economic and military actions. Considering the challenges presented by the constitutional reform plans, President Putin may choose to prioritise domestic and economic problems while also keeping an eye on the foreign policy.

The US shale oil industry: The US more than doubled oil production and became a world leader thanks to the new shale technology, which facilitated horizontal drilling and fracking. The shale companies successfully survived the 2014 oil price crash through efficient management and usage of modern technologies. While the shale industry managed to reduce their breakeven from 60 to 40 USD, they are struggling to decrease production costs further. This dead-end limits their flexibility and ability to compete with other companies, specifically cost-efficient Russian state energy conglomerates.

During the oil price war, most of the shale companies struggled because of their immense debts and inability to cover the extraction costs. Such an unstable environment paved the way for bankruptcies and acquisitions, where only the most efficient companies will continue. The situation may show similarities with the late 1990s when oil prices averaged 10 USD, and the BP buyout of Amoco and the ExxonMobil merger took place. These examples are the main reason behind the silence of the major oil companies. They do not request the federal government's help so that they can buy smaller companies with profitable prices after their prospective stock market crash.

President Donald Trump mentioned the importance of saving shale businesses and jobs. Seventeen shale companies have already demanded state protection from bankruptcy since the start of the year. Rystad Energy estimated that almost 73 shale drillers could be forced to cease business by the end of the year if the market does not miraculously flourish post-crisis. The main problem resides in the absence of consumption, which would trigger the return of oil demand.

On the positive side, millions of Americans have benefitted from cheaper energy prices and job losses in the oil industry have led to the creation of new jobs in other sectors. However, the pandemic has hit energy industries harder and has created millions of unemployed citizens regardless of their involvement in the oil business.

The US oil standard WTI recorded two momentous events within a month. After its sharp fall below zero on Black Monday, WTI showed extraordinary performance and rose again. Currently, WTI Crude is trading at close to 35 USD p/b compared to Brent Crude at 39 USD p/b and Mars US at 38 USD p/b. It is a remarkable gain from the last few days of April 2020, and it gives hope to analysts about the future of the crude market. The prevailing hope of traders is to see prices go over 50 USD, which can save shale industries and even let them begin to profit. It can also give pre-crisis assurance to investors.

However, other analysts are not very hopeful. The predictions of a possible second wave of Covid-19 and another price war between Moscow and Riyadh makes expectations of WTI going back to 50 or 60 USD p/b unrealistic. Also, the speed of Chinese recovery, sanctions on Iran and Venezuela, and the stance of OPEC+ are noteworthy aspects that US producers need to consider.

Other losers: Apart from the major players mentioned above, OPEC producers who do not possess refining capacity and lack long-term oil supply agreements with buyers are also severely affected by the oil price war.

In the Americas, notable losers are Venezuela, Ecuador, and Colombia. US sanctions have been already devastating the Venezuelan economy for a long time, and the collapse of global oil prices hit cash reserves of the state-owned oil company PDVSA. The possible collapse of PDVSA can hurt Maduro's government, which requires higher oil prices. Colombia will also suffer from any price under 45 USD p/b, while Ecuador might default on its debt. On the other hand, Mexicans were set to lose about 0.15% of their GDP before the April agreement. Thanks to the US action, Mexico managed to decrease its share of oil cuts. This move also helped them avoid the devaluation of the peso for now.

In the Asia-Pacific, the Australian currency continues to suffer instability. The Australian market has close ties with the Chinese economy, and the outbreak has affected trade negatively. According to Bloomberg, Australia may suffer 1.5% lower growth than expected. Of course, this will be dependent on the recovery rate of the Asian markets.

Apart from Saudi Arabia, there are substantial losses in other oil exports of the MENA region as well. Oil and gas exports comprise almost 85% of Algeria's exports, and the government fears increased political instability due to the low oil prices. The country is still trying to recover from the 2014 crisis as other non-diversified oil economies. Iran is one of the major oil exporter countries. Therefore, Tehran suffers massively from both US sanctions and the Covid-19 pandemic.

What is expected?

The oil price war of 2020 is mainly structured around the imbalance between supply and demand. Political moves and the pandemic have made the price war unique – but not extraordinary. Historically, Saudi Arabia decided to rapidly increase its production in 1985, which directly affected the dissolution of the Soviet Union in 1991. However, today's conditions are different. The global economy is only a step away from recession, and influential world powers like the US are also part of the problem. The agreed cuts in April can only delay recession for a time since cutting 10 million barrels per day does not fully recover the fall of 30 million barrels per day in demand.

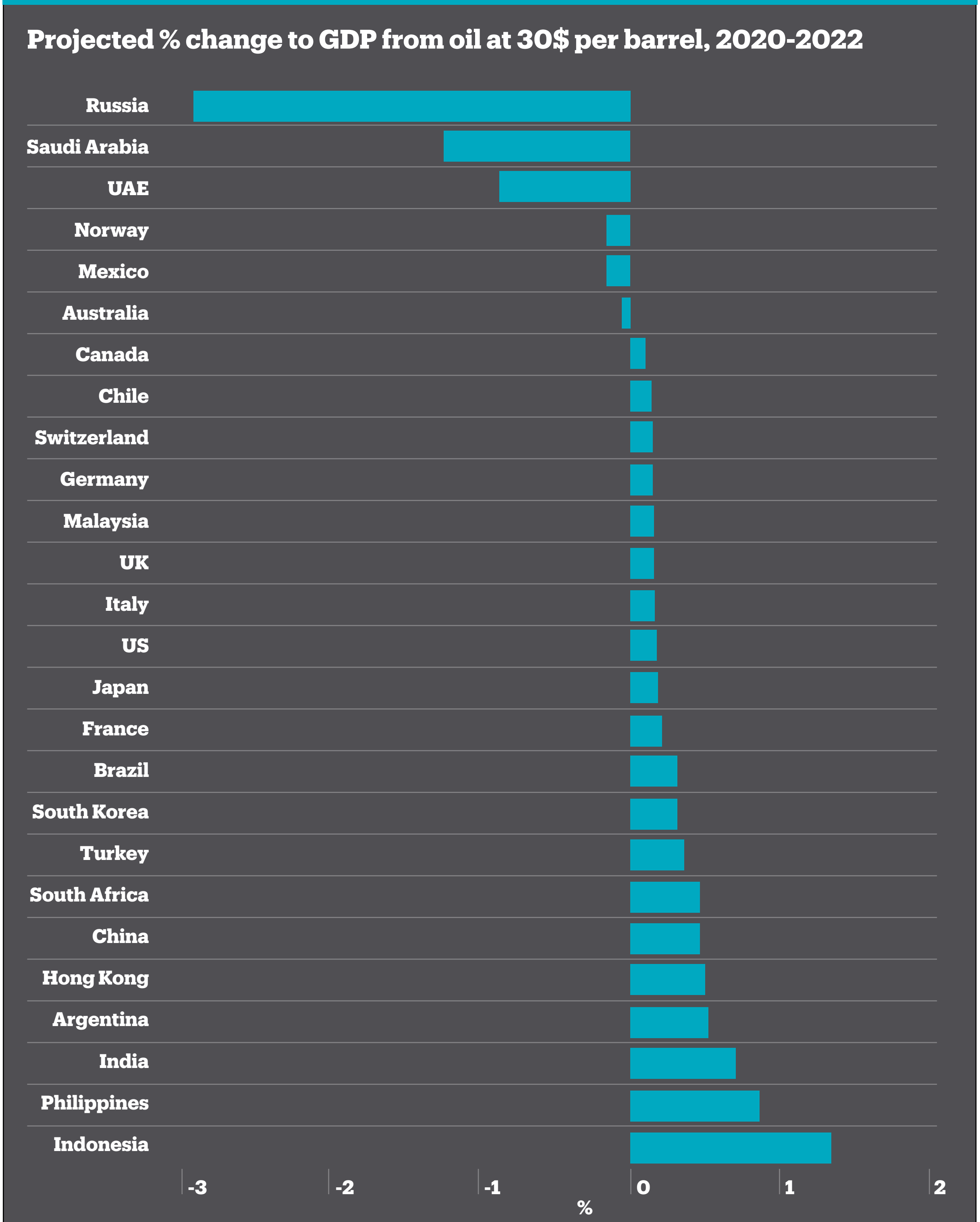
The pandemic will directly affect the decline in energy investments this year, which is calculated to be around 400 billion USD. This decline represents the most significant annual fall ever. The IEA warns that this situation could push global economies to become more dependent on cheaper and dirtier fossil fuels. According to the IEA, China has been increasing the usage of coal and approved new coal plants to be built in early 2020. The climate crisis needs to be addressed, and opting for cleaner energy research and investment is a choice that many are willing to make.

The fate of WTI and Brent Crude is also uncertain. Some experts argue that the Chinese post-pandemic recovery can trigger an increase in oil imports and restore prices to their earlier levels. According to such optimistic forecasts, oil prices will hit higher than 30 USD p/b depending on increased demand by the end of the third quarter, and increasing storage facilities will let the market stabilise. However, some industry professionals do not submit to these views, and, in contrast, carry pessimistic views about the fate of both spot and future sales. They argue that the global economy had already witnessed peak oil demand when the global need was 100 million barrels p/d. By the end of May, major analysts continue to hold on to their hopes for recovery, since countries around the world slowly reopen for business, ease lockdown measures, and call for the return of the transport industry. According to Bloomberg, Chinese demand for oil is also getting closer to pre-pandemic levels.

Russian President Vladimir Putin and Saudi Crown Prince Muhammad bin Salman agreed on close coordination before the OPEC+ meeting that took place in June. It gave a positive image to the markets, which are in fear of any possible Russian-Saudi clash once again. OPEC+ mostly met its cutting targets in May, while oil prices increased after the latest cartel meeting that decided to further cut 9.7 million barrels p/d until July. Accordingly, Goldman Sachs increased its 2020 expectancy for Brent crude oil to 40.40 USD p/b and WTI crude to 36 USD p/b. However, some experts argue that the figures are too sanguine and that with a currently volatile end date for the pandemic, analyses for prospective prices are almost impossible.

In conclusion, there are several ways according to analysts to ease the adverse effects of the oil price war. First is the recovery in global demand. Chinese recovery, in particular, plays a vital role in the future of oil prices. However, China's growth rates are not at the same height as they were a few years earlier; the global pandemic will ensure that this year will be less profitable for Beijing. In these circumstances, it would be too optimistic to predict an immediate increase in demand and a quick recovery for oil prices. Secondly, further cuts can be made. The April agreement between OPEC and G20 patched the problem temporarily since the actual fall in demand is three times higher than production cuts. The reserves in more advanced economies, such as the US, India, and China are almost full, and further cuts can also leave thousands of businesses out of the market while millions can suffer from unemployment. This prediction may contradict the defensive approach for further cuts to balance the state budgets. However, the reality is that the industries related to the oil products are already started to revise their economic policies. For example, BP, which decided to cut 10,000 jobs worldwide, declared that it would increase its focus on alternative energy. The oil exporters with long-term supply contracts can likewise feel safe for a short time compared to spot crude traders. However, any possible recession in global markets would affect them in the long run as well. Overall, the outlook for the oil industry remains in flux and an uncertain future beckons for the various winners and losers of the price war.

Oil Changes



Source: Oxford Economics

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