Saudi Arabia's Unwinnable Oil Price War Against Russia?

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See footnotes at end of text.

The coronavirus outbreak could go into history as the largest destructive event that has hit the global economy since the Six-Day War in 1973. Indeed its impact could prove to be far bigger than both the financial crisis of 2008/9 and the 2014 oil price crash.[1]

Whilst both the financial crisis of 2008/9 and the 2014 oil price crash very adversely affected the global oil economy, the outbreak has paralysed the global economy and brought normal economic activities to a virtual standstill in addition to the immense damage inflicted on the global economy which is yet to be assessed.

2020 started with positive projections that the global economy is set to grow at 3.3% with global oil demand adding 1.2 million barrels a day (mbd) over 2019. But this was not to be. The outbreak changed everything.

The world has never faced such a lethal and destructive cocktail as the coronavirus outbreak, global recession, huge glut in the global oil market and an oil price war in the last fifty years.

Until the coronavirus is completely controlled, the world would continue to face huge challenges on daily basis.

Saudi Arabia Wields the Oil Price War Weapon

History is repeating itself. Since the early 1980s Saudi Arabia has wielded the oil price war weapon three times unsuccessfully.

Early in the 1980s, Sheikh Ahmad Zaki Yamani, the veteran former oil minister of Saudi Arabia, suddenly awoke to Saudi Arabia's need for market Share. He flooded the market with oil causing the oil price to collapse to $10/barrel. It later transpired that the Saudi need for market share was just a cover for a CIA-Saudi conspiracy to expedite the downfall of the Soviet Union with the Reagan administration starting a costly arms race and Saudi Arabia depressing oil prices by flooding the market. Saudi Arabia ended bankrupting itself in the service of the United States.[2]

In the aftermath of the 2014 crude oil price crash, oil prices lost 54% of their value and there were no indications that it will stop there in the absence of a major production cut by OPEC. At one point the price fell to $30.

Countries	2013	2014	2015
Iraq	86	74	55
Kuwait	92	72	54
Qatar	42	34	25
Saudi Arabia	274	208	156
UAE	53	42	31
Oman	27	22	19
Total	574	452	340

Table 1 Net Oil Export Revenues of the Arab Gulf Oil Producer (US$ bn)

Source: U.S. Energy Information Administration's (EIA) 2014 Short-term Energy Outlook (STEO) / Author's projections for earnings in 2014 & 2015.

Instead of agreeing to production cuts with OPEC, Saudi Arabia ignored OPEC and flooded the global oil market with oil. Circumstantial evidence suggested some political collusion between Saudi Arabia and the United States behind the steep decline in oil prices aimed against Iran and Russia.

Saudi Arabia took advantage of the low oil prices to inflict damage on Iran's economy and weaken its influence in the Middle East in its proxy war with Iran over its nuclear programme whilst the United States used the low oil prices to weaken Russia's economy and tighten the sanctions against Russia over the Ukraine.[3] Yet again, Saudi Arabia ended up losing $118 bn in oil revenue (see Table 1). It also sustained huge budget deficits of $140 bn in 2015 and $134 in 2016.[4]

With prices falling by more than 50% as a result of the coronavirus outbreak since hitting £60 in January, OPEC+ met on the 6th and the 7th of March to discuss new production cuts or deepening existing ones. Saudi Arabia called for deeper cuts amounting to 1.0 million barrels a day (mbd) at a time when Libya's oil production had already lost 1.0 mbd.

Russia refused to agree to deeper cuts arguing that they will have no positive impact on oil prices whatsoever while the coronavirus is raging. Russia's position was that OPEC's proposal for cuts of between 600,000 barrels a day (b/d) and 1.5 mbd would have been 'a drop in the ocean' in a market where oil demand is plunging fast. Considering that oil demand is now already down by 15 mbd and could reach 20 mbd in coming weeks, influencing the market with the cuts proposed by Saudi-led OPEC would have been impossible.[5]

Russia's refusal was the last straw for Saudi Arabia so it decided rashly to wage a price war against Russia and flood the global oil market with oil.

The rationale for Russia's refusal is not without merit. Russian oil companies couldn't switch off oil production at their oilfields as easy as U.S. shale oil for instance. Moreover, any cuts will have no impact on oil prices without the United States doing its bit, which it will not. The U.S. shale oil industry has been gaining more market share at the expense of OPEC+ producers.

Moreover, Russian oil companies have always been against any production cuts by OPEC+ arguing that they have invested heavily in expanding Russia's oil production capacity and therefore they wanted a quick

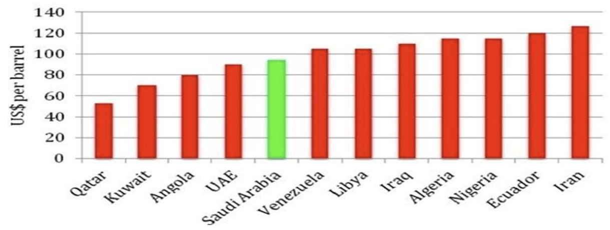

Figure 1. OPEC Median Budgetary Break-even Price
Source: OPEC "Break-even" Prices (Matthew Hulbert/European Energy Review).

return on their investments. They also argued that OPEC+ cuts would have extended a lifeline to a sinking U.S. shale oil industry.

Saudi Oil Price War

Despite the bravado, Saudi Arabia can neither win a price war with Russia nor is able to flood the global oil market with oil for the following reasons.

The first reason is that Russia's economy can live with an oil price of $25 a barrel for years compared with $85-$91for Saudi Arabia's (see Figure 1). Moreover, Russia's economy is highly advanced and well diversified compared with Saudi Arabia's overwhelmingly dependence on oil revenues.

The second reason is that Saudi Arabia doesn't have the production capacity to flood the global oil market with oil. Saudi Arabia has never ever had a production capacity of 12.5 mbd as it claims and will never ever achieve one. So the talk about raising its exports by 3.0 mbd is a farce. Its production peaked at 9.65 mbd in 2005 and has been in decline since.[6] Saudi Arabia can at best produce some 8.0-9.0 mbd with another 700,000 b/d to 1.0 mbd coming from storage. Current Saudi production comes from five giant but aging and fast-depleting oilfields discovered more than 70 years ago.

The third reason is that the lifting cost per barrel of Russia's largest oil producer, Rosneft, is now lower than that of Saudi Aramco. This is due to the falling ruble against the dollar. Russian oil companies earn dollars and other hard currencies for their exports but pay for their operations in ruble. The lower the ruble slides against the U.S. dollar, the lower the production costs of Russian oil companies. As a result, Rosneft's costs per barrel have fallen from $3.1 to $2.5 compared to a $2.80 for Saudi Aramco.[7]

Without the influx of billions of dollars of oil money, multi-billion projects that are deemed vital for Vision 2030 for the diversification of the Saudi economy will be delayed or even shelved indefinitely. Moreover, the economy will not be able to create more than 6 million jobs needed to employ Saudi Arabia's youth. The economy could crash on the back of an oil price war with a mushrooming budget deficit estimated at $116 bn.

To this could be added another loss of $200 bn being a 10% devaluation of Saudi Aramco's shares raising the total to $316 bn. Moreover, the devaluation of Saudi Aramco shares is a major threat as Saudi citizens have been investing not only their own money but also borrowed money from banks to buy Aramco shares.[8]

The stability of Saudi Arabia depends on the Aramco domestic IPO, Public Investment Fund projects and diversification. All can be linked directly and indirectly to OPEC+ and oil prices.

If Saudi Arabia continues with its price war, it could end depleting both its sovereign wealth fund and its stored oil not to mention ending with probable bankruptcy of its economy and destabilization of the country.

The biggest loser in the current situation is the global economy and within the global economy the two largest losers could be Saudi Arabia and the U.S. shale oil industry.

Impact on U.S. Shale Oil Industry

Since its inception in 2008 the U.S. shale oil industry has never been profitable. If it was judged by the strict commercial criteria by which other successful companies are judged, it would have been declared bankrupt years ago.

U.S. shale drillers have been encouraged by easy liquidity provided by Wall Street and other investors to continue production even at a loss to pay some of their debts. In so doing, their outstanding debts have mushroomed to hundreds of billions of dollars leading to large number of bankruptcies among them.

And with a breakeven price ranging from $48-$68 a barrel and a well depletion rate of 70%-90% after first year production, the overwhelming majority of shale drillers can't survive low oil prices let alone a price war.

At $30-35 oil, U.S. oil production could drop by around 1.5 mbd according to Russia's oil ministry. According to Russia, a $45-$55 a barrel is a fair price for oil currently. Such a price range would discourage costly projects and allow demand to grow.[9]

Still, President Trump's administration is under pressure to keep the industry alive even if on life support not only because it is a $7-trillion industry employing more than 2% of the work force and therefore very important for the U.S. economy but also because it enables the United States to have a say in the global oil market along Russia and Saudi Arabia.

Many ideas are being considered for bailing it out including an import tax on all foreign oil imports to the US. One of these ideas sees the United States imposing a fee on imported oil or products. It engenders setting a floor price of $50 a barrel. So if the import price goes down for instance to $30, then an import fee of $20.00 per barrel would be paid to the United States Treasury. Likewise, if the import price is $50.00 a barrel or higher, then no fee is paid.[10]

Calling it a fee doesn't change the fact that it is a tax. It is no more than an opportunistic way to fleece the oil-exporting countries and save American tax payers the cost of bailing out the shale industry.

Impact on Oil Prices

Crude oil prices have more than halved since hitting $60 in January and could be expected to even fall to $20 a barrel with oil majors even preparing for $10 oil.[11]

Saudi Arabia has already announced that it is reducing government expenditures by US$13.2 billion, or nearly 5% of its budget spending for 2020.[12]

Saudi Arabia says it can adapt to today's lower oil prices, but analysts are not buying this claim. Saudi Aramco Chief Executive Amin Nasser even claimed that his company is very comfortable with $30 oil.

At $30 a barrel, the Saudi wealth fund will deplete fast and reduced government spending will stall projects and increase the suffering of the non-oil sector. That's the near-term damage. The longer-term damage is the lack of funds for Vision 2030 which was already going downhill even before the oil price collapse as the promised multibillion foreign investment wasn't materializing. Saudi Arabia could go bankrupt in less than two years if the oil price remained at $30 a barrel.

Globally, the double supply-demand shock in the oil market could lead to companies deferring as much as $131 billion worth of oil and gas projects slated for approval in 2020.[13]

President Trump has been blowing hot and cold about the price war. On the one hand, he threatened to invoke the NOPEC bill to force Saudi Arabia to end the price war. Under NOPEC, the United States could sue OPEC for alleged price fixing.[14] However, this is an empty threat as OPEC is not a cartel and has never been one throughout its history. It won't stand scrutiny in a court of law. Moreover, it is the United States who has been manipulating oil prices for years.

On the other hand, The United States and Saudi Arabia have been discussing the idea of setting up an oil accord, Bloomberg reports, citing U.S. Energy Secretary Dan Brouillette. Such an accord would effectively amount to a cartel, which, by definition, is a group of independent market participants agreeing to act together to influence the market in a way favourable to them.[15] But no decision has been taken yet.

However, for the United States to join Saudi Arabia in a new cartel proves not only that it is a hypocrite but it also undermines the NOPEC bill and exposes the United States' double standards where its interests are involved.

There is, however, a chance to rebalance oil markets if OPEC+ expands to include more producing countries, the head of the Russian sovereign wealth fund, Kiril Dmitriev, told Reuters in an interview.[16] However, this could never work without U.S. involvement which isn't forthcoming. It has become patently obvious that efforts by OPEC+ in the past to deplete the glut and arrest the slide of oil prices are being undermined by the U.S. shale oil industry recklessly producing even at a loss and gaining market share at the expense of OPEC+ members.

Saudis Not Bowing to Trump Admin Pressure to End Oil Price War

Saudi Arabia is resisting pressure by the Trump administration to end the price war according to a report by Aljazeera Satellite Television as quoted by Reuters.[17]

Saudi Arabia's latest move has put Washington in a difficult position. Saudi battle for market share has led to very low prices, but also undermined the shale industry.

A group of six U.S. senators wrote a letter to U.S. Secretary of State Mike Pompeo in the last week of March saying Saudi Arabia and Russia "have embarked upon economic warfare against the U.S."[18]

They called on Saudi Arabia to quit OPEC, reverse its policy of high output, partner with the U.S. in strategic energy projects or face consequences including tariffs, sanctions and much else.

Conclusions

Saudi Arabia risks being blamed for exacerbating the damage to the global economy by its price war. Moreover, by continuing the price war the Saudis are digging themselves deeper into a hole and facing bankruptcy of their economy and a destabilization of their country.

The Saudis have been for years hoodwinking the world about the size of their proven oil reserves and their production capacity and they are now at it again by claiming that they are comfortable with a $30 oil and that they can flood the market with more oil from the 1st of April. Nothing is further from the truth.

Once the coronavirus outbreak is controlled, the global economy particularly China's will behave like somebody who has been starved of food while in quarantine. Once allowed to eat, his appetite will be rapacious and that will exactly be the same with the global oil demand which will probably double or perhaps triple oil imports to compensate for lost demand.

Soon the outbreak will be history with global oil demand and prices recovering all their recent losses.

Footnotes

1 Based on Dr Mamdouh G Salameh's research and evaluation.

2 Mamdouh G Salameh, "What Is Behind the Steep Decline in the Crude Oil Prices: Glut or Geopolitics", published in September 2015 by the Arab Centre for Research & Policy Studies in Qatar.

3 Seyed GholamHosein Hassantash, "Naimi in Yamani's Attire; Are Authorities in Riyadh Witless or Lying? History is Being Repeated", IAEE Energy Forum, 1st Quarter of 2015, p.21.

4 Mamdouh G Salameh, "Saudi Arabia's Vision 2030: A Reality or Mirage" posted by the USAEE Working Paper Series on 13 July 2016.

5 Tsvetana Paraskova, "Russia Sees Oil Market Balance in 2021", posted by oilprice.com on 27 March 2020 and accessed on 28 March.

6 Mamdouh G Salameh, "Saudi Aramco: A Global Oil Giant with a Global Credibility Gap to Match", posted by the Research Centre of Energy Management (RCEM) at ESCP Europe Business School in London on 13 May 2019.

[7] Tsvetana Paraskova, "Russia's Unexpected Advantage in the Oil Price War", posted by oilprice.com on 25 March 2020 and accessed on 27 March.

[8] Tsvetana Paraskova, "Saudi Arabia's Oil Price War Is Backfiring", posted by oilprice.com on 22 March 2020 and accessed on 27 March.

[9] Tsvetana Paraskova, "Russia Sees Oil Market Balance in 2021", accessed on 28 March 2020.

[10] Lourcey Sams, "The Cheapest Way for Trump to Save US Oil", posted by oilprice.com on 27 March 2020 and accessed on 28 March 2020.

[11] Nick Cunningham, "Oil Majors Are Preparing for $10 Oi", posted by oilprice.com on 23 March 2020 and accessed on 26 March.

[12] Tsvetana Paraskova, "Saudi Arabia's Oil Price War Is Backfiring", accessed on 27 March 2020.

[13]Tsvetana Paraskova, "Oil Price Crash Could Wipe Out $131 Billion in New Projects", posted by oilprice.com on 24 March 2020 and accessed on 28 March.

[14] Simon Watkins, "Trump's Ultimate Weapon to End the Oil War", posted by oilprice.com on 22 March 2020 and accessed on 27 March.

[15] Irina Slav, "Saudi Arabia & the US Could Form the World's Newest Oil Cartel", posted by oilprice.com on 24 March 2020 and accessed on 25 March.

[16] Irina Slav, "Is It Possible to Rebalance the Oil Market?" posted by oilprice.com on 27 March 2020 and accessed on 28 March.

[17] Saudis Not Bowing to Trump Admin Pressure to End Oil Price War", a report by Aljazeera Satellite TV quoted by Reuters.

[18] Ibid.,