Oil and Virus – A Volatile Mix

Tom Harley / David Pickavance

Current situation

Developments over the weekend indicate that an accommodation on oil production has been reached that will see reduced supply and potentially collective efforts to manage oil prices back to levels that avoid extreme imbalances and economic shock in producer nations.

Russian President Putin, by taking the lead in offering production cuts, may have provided the enabling step – effectively mutual self-interest – that the Saudi leadership and others who drive up production may need. Direct appeals to Saudi Prince Mohammed Bin Salman (MbS) by a number of Texas Congressmen and Senators and no doubt US President Trump's own intervention will have aided momentum. President Putin made a point in his public remarks of saying that Russia was open to co-operation with the US on the issue.

President Putin has asked for an OPEC+ meeting on Monday and suggested a production cut of 10 million barrels a day. If that is achieved, it may be that a serious debacle will be averted. We outline below some of the larger issues that emerge should persistent extreme weakness in oil prices fail to be averted.

The oil industry has had a double blow which cumulatively is the greatest shock the industry has had in its history. A large increase in supply from its lowest cost producers and a massive drop in demand have combined to smash the economic orthodoxies of many decades. The consequences for global politics are significant.

In the Middle East this will mean greater instability and risk. In the USA it means massive disruption to both the exploration and production industries, as well as the resources and mining industries. To global shipping and freight companies it is a massive blow, on top of the non-oil impacts of the virus. And to many fragile states that are reliant on oil, it snatches away revenue when it is most needed, with implications for regime stability.

How we got here

At the February meeting of OPEC Russia refused Saudi demands to reduce its production, which was an attempt to offset the lower oil demand related to COVID-19 and to support a price of US $40 to $50 a Barrel (bbl). The Saudis reacted with a blunt and costly exercise in power and used their swing capacity to increase supply from 9.7 million barrels per day (bpd) to 12.3 million bpd. We understand that Riyadh also has plans for near-term domestic investment of over $10 billion to further increase production capacity to 13 million bpd or more.

The Saudis have two primary objectives; to force Russia back to the OPEC table to lower production and raise prices, and a shared objective with Russia to capture the market share of other suppliers that have higher cost bases – notably US shale producers.

Russia followed suit by announcing increased production, and Abu Dhabi's ADNOC said it would also increase production from 3 to 4 million bpd with a goal of 5 million bpd.

A supply increase of 5%-10%, coupled with a short-term fall in demand of around 20% of global consumption as a result of the pandemic, saw oil prices as low as US$20/bbl.

Oil and petrochemical storage will be the next driver of price – as storage reaches capacity around the world, producers are shutting in production and prices are forecast to fall further.

Economic, social and political impacts

The actions by Saudi and Russia play out in different ways across the globe. Below we touch on a few countries of significance.

Saudi Arabia: Global player or miscalculation on a grand scale?

Although Saudi Arabia can produce oil economically at prices as low as $9/bbl, the government required oil prices of $83/bbl to fund its pre-Virus budget.

Goldman Sachs believes that oil prices of $30 with a 10% increase in production will cause Saudi Arabia's budget deficit to grow to 12% of GDP (from 6.4% last year), compared to 4.6% deficit in the USA and a surplus of 0.9% in the UK prior to virus-related stimulus. With a $20/bbl oil price the IMF estimates that Riyadh can spend until 2027 before it exhausts its substantial $500 billion foreign reserve.

After previously asking government agencies to cut their budgets by at least 20%, the Saudi Finance Ministry and the Saudi Arabian Monetary Authority (SAMA) have been designing government expenditure plans that can sustain oil prices falling as low as $30/bbl on average, with occasional dips to $15/bbl, for at least the next five years.

These budget cuts could fundamentally change the Kingdom's social contract and impact the political stability in the country.

The gamble for Saudi Arabia is whether its moves will allow a long-term restoration of at least modest prices and that those modest prices will supplant or delay the global switch to non-oil energy options ultimately increasing demand.

The move has stirred anti-Saudi sentiment in the US and has acted like a wrecking ball through the economies of the shale states and refining centres.

While MbS's actions are often described as impulsive, his processes are simply more tactical than strategic. His lack of experience has been made obvious with the Khashoggi murder, the military intervention in Yemen, the blockade against Qatar, the detention of Hariri and, now, the damage done to the Aramco float and his domestic economic strategy by the drop in oil prices.

The consequence of MbS's tactical, near-term thinking is that Saudi Arabia is, and will be weaker both in the Middle East and in its relationship with the West than it needs, or wants, to be. It is hard to see the measures holding for three years especially with strong antipathy from US leadership. The Saudi position is also hostage to President Putin. Put has a long record of playing well a poor hand, and may have more tactical awareness than the Crown Prince.

Iraq: A major destabilising factor with a high risk of a return of ISIL

Iraq's economy is dependent on oil for 90% of its revenue, requiring $60/bbl to fund its proposed 2020 budget. At current prices, the country will need to borrow $4 billion per month to keep the government running. Iraq's fragile governance is particularly vulnerable. The series of unstable governments had already been challenged by anti-government protests that rallied against endemic corruption, high unemployment, dire public services and foreign interference – including from neighbouring Iran. Further breakdowns of order will allow a vacuum for ISIS to fill – with global consequences.

Iran: The political order is fighting for survival, oil price fall will put more pressure

Kleptocratic Iran's economy is already strangled by US-led trade sanctions and suffering from political mistrust and social unrest, upon which coronavirus has created a major health and economic crisis. Despite the Iranian economy not having the same oil dependency culture that afflicts its gulf neighbours, it will be hard hit by a fall in oil revenues.

Confidence in the key elements of Government has been severely eroded, as seen in recent violent protests over government attempts to reduce fuel subsidies, perceived incompetence in dealing with Ukraine International Airlines Flight 752 and coronavirus, as well as crippling rivalries and internal conflict between religious / military and civilian centres of the government. The religious leadership is geriatric and has already suffered losses of key individuals from the virus. Supreme Leader Ayatollah Khamenei is attempting to redirect anger and mistrust towards the US and bolster support for the regime, but it is quite likely the additional economic impact of lower oil prices will drive further political unrest and major changes in the regime.

Leaders within the region are apprehensive about the potential for change in Iran given the uncertainty about the direction – will it be a more hard-line version of the same or a regime dominated by the Iranian Revolutionary Guard Corps?

Gulf Cooperative Council: UAE’s downside is Qatar’s upside

The United Arab Emirates has supported Saudi Arabia by increasing production. However, the UAE, and especially Abu Dhabi, are heavily reliant upon oil income and have a breakeven budget price of around $70/bbl. The combination of depressed oil prices and COVID-19, which has caused the tourism, aviation / transport, trade and real estate markets to tank, will have a massive impact on the UAE, especially Dubai. Fissures have opened in the UAE’s relationship with Saudi over Yemen. The oil price tactic which is MbS’s initiative and is prosecuted to some extent at a cost to the UAEs be a test of friendship.

Qatar has negligible population demands and revenues heavily tied to long term gas contacts, and will experience some revenue cuts but will feel the pain the least of all. Qatar airlines continues to be the most active global airline, exploiting the pressures on other Gulf and international carriers. Doha’s foreign policy is built on its abundance of cash and its nimbleness – both factors it will exploit through the crisis.

The Maghreb: Weakened and anarchic states invite more interference when their revenues shrink

Algeria and Libya are highly dependent on oil exports, and both face budget price requirements of $100-110/bbl. To manage the impacts of collapsed oil prices, Algerian President Abdelmadjij Tebboune ordered the government to reduce expenditure by 30% and delay all planned state projects. This is likely to exacerbate mass protests currently waged against corruption.

In Libya, the civil battle for control of the oil fields has cut domestic production, and extended low prices will be devastating to the economy. Recent peace processes have failed, and violent crimes towards and abductions of civilians, journalists and state officials by rebel groups have increased. Further disruption will delay Libyan production and will support the Saudis taking greater market share.

Venezuela: even more at the mercy of Russia

Outside of North Africa and the Middle-East, OPEC member and Russian ally Venezuela is an economy on “life support” that, due to years of economic mismanagement, ostracism by the West and corruption, has collapsed by more than 60% over the past five years. With a history of overspending on dwindling oil revenues, Venezuela relies on oil revenue to fund 85% of government expenditure, far greater than even neighbouring ex-OPEC country Ecuador, at 35%.

A UN report estimated in March 2019 that 94% of Venezuelans lived in poverty, while 25% need some form of humanitarian assistance. More than 10% of Venezuelans (3.4 million people) have left their country. Venezuela already has the third highest murder rate in the world.

Its dependence on Russia will increase and the prospect of insurrection will also rise.

Nigeria

With storage limited at only two days of production and lifting costs of around $30/bbl, Nigeria will need to significantly reduce production before most OPEC countries. Foreign reserves of only $30 billion will not keep the economy afloat for long when Government expenditure has totalled $35 billion annually. As the largest economy in Africa, this could have a destabilising effect on its government and the region, with the beneficiaries being extremist groups.

United States of America

In normal times, the US's vast and highly diversified economy would benefit from lower energy and feedstock prices. But its oil sector, and particularly the highly leveraged and high-cost onshore shale oil industry, are in crisis. Forecasters predict that sustained prices of $20-30/bbl will see around 35-50% curtailment of US shale oil production by the end of 2021. This equates to 4 million to 5 million stock tank barrels (stb) being removed from the market, a reduction in global supply of around 5-6%.

President Trump has previously criticised OPEC for not releasing more oil to the market, while claiming credit for the USA's transition to both energy independence and energy dominance. The President's response has been to aid the highly indebted shale oil companies to prevent bankruptcies and massive job losses in an industry that IHS Markit claims employs around 2.5 million Americans – inconveniently concentrated in Trump-centric states.

The President's recent move to purchase around 77 million bbl to completely fill the US strategic reserve to boost prices has been criticised as helping his wealthy friends and cronies in the fossil fuel industry, and contrasted with his previous nonchalance towards COVID-19. Further interventions are expected from the President as more companies file for bankruptcy. His most potent intervention would be to pressure MbS into changing his position and reducing production.

The US government has been expressing their concern to the Saudi authorities, including sending officials to Riyadh to work with the Saudis to "stabilise" prices. There is little downside in the US to picking a fight with Saudi Arabia. In contrast, the implications for the Crown Prince of losing the support of his most important backer are significantly higher. A Biden presidency would be even less accommodating of Saudi adventurism than the incumbent.

China

As a major importer of oil, China's economy should be stimulated by lower prices. Notably, the country has a goal of energy security, and fears that such low prices may cause their own national oil producers (Sinopec and China National Petroleum Corp) and other diversified suppliers to become uneconomic, much like the USA's shale oil industry. Lower prices will also disincentivise development of domestic sources of renewable energy – a key to China's energy self-sufficiency and decarbonisation / pollution reduction initiatives.

For this reason, China has upheld its $40/bbl equivalent floor prices on retail pricing of gasoline and diesel, as set by the National Development and Reform Commission (NDRC), intended to protect China's companies from extreme volatility in international oil prices. The floor means that the domestic economy will not experience the fillip of sub-$30/bbl prices that will no doubt stimulate other importing countries but will generate significant revenue for the Government.

Russia

To counter the impact of international sanctions related to its military intervention in Ukraine, Russia has attempted since 2014 to strengthen and insulate its economy, boosting its domestic industries and lowering debt while building a strong foreign reserve. Nonetheless, endemic corruption and a huge military budget have weakened the state, with GDP growth only 1.3% in 2019, much of that due to state-owned investment. The economy was already faltering and faced the prospect of a recession as trade with China slowed due to coronavirus. By all accounts Russia's preparedness for the coronavirus has been cursory.

Heavily dependent upon hydrocarbons priced at $42.40/bbl for its budget, Russia initiated the current glut in production after refusing Saudi requests to reduce production, claiming that volume reductions by OPEC+ would simply be replaced by US shale oil. Russia's production costs average $19.21/bbl – not dissimilar to US at $20.99/bbl for non-shale costs (and $23.35/bbl for shale oil). At current and likely near-term prices, there will be limited revenues derived by the state.

President Putin won't admit to the scale of the virus's impact on his society. It is large and threatening and will reflect upon him. He will need funds to address it. In our view, he will have to be the first to blink in the stand-off.

Tom Harley

Dragoman Managing Director Tom Harley is a political scientist with an economics and finance background. Tom was the founder of Dragoman in 2009. In 2019 he was appointed as one of the 3 Australian members of the APEC Business Advisory Council. He is a member of the Advisory Board of the Centre for Arab and Islamic Studies at the Australian National University and Chairman of the Australia Saudi Business Council. From 2008 to 2018, Tom was non-executive Chairman of Dow Chemical (Australia) and Senior Advisor to The Dow Chemical Company's Executive Leadership Team (Globally). Tom was President of Corporate Development at BHP Billiton, where he designed and implemented BHP Billiton's worldwide political risk analysis methodology and developed strategies in countries where BHP Billiton wanted to do business – including some very challenging African and Asian countries.

David Pickavance

David Pickavance is Director, Energy and Resources at Dragoman. David has extensive experience in the resources industry in geotechnical, valuation and governance role. He managed the investment process for BHP's major capital projects and transactions, and was secretary for BHP's Investment Committee,