مركز البحرين للدراسات الاستراتيجية والدولية والطاقة
دراسات
DERASAT
Bahrain Center for Strategic, International and Energy Studies

Derasat Reports
April 2020

Implications of the Coronavirus Crisis:
Oil Markets

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This report discusses the course of events that preceded the decline in oil prices, in light of the Coronavirus crisis and the collapse of the OPEC + deal. These two events inflicted a shock on the oil market causing prices to fall significantly. The report illustrates the development of the Russian-Saudi disagreement over the optimal policy towards oil markets, amid continued production growth by shale oil, and how this disagreement escalated towards the collapse of the OPEC+ deal in a meeting last March. The report also reviews US responses and the instruments available to the US government to deal with this crisis.

1. Introduction

From the Arab Gulf states perspective, one of the most significant damaging factors of the Coronavirus crisis is its negative impact on oil prices. This report analyzes the nature of these implications in general, while pointing out that absorbing the impact of the Coronavirus crisis requires understanding the Opec+ deal situation, which developed in a manner independent yet parallel to the Coronavirus crisis. This report presents the following deductions:

1. In the period prior to the Coronavirus crisis, the Opec+ deal enabled shale oil producers to enhance their production and market share at the expense of Opec+ countries.
2. These developments led to a Russian–Saudi disagreement around oil markets that preceded the Coronavirus crisis, and in turn caused the OPEC+ deal to collapse.
3. The impact of the Coronavirus crisis on oil prices will be sharp and momentary, yet assessing this impact is quite difficult due to the complications of the crisis, and the uncertainty of its course.

2. The Negative Impacts of the OPEC+ Deal

The OPEC+ deal provided a chance for shale-oil producers to enhance their production and market share.

From the onset of the shale-oil revolution, OPEC faced a chronic ordeal of coping with the oil surplus offered in the market. OPEC members need high oil prices to balance their government budgets, and to achieve that they need to reduce production and give up market shares.

Opting to reduce oil production and hike prices in the short-term usually encourages shale-oil producers to continue increasing their output, leading to medium-term price reductions and OPEC's loss of market shares to shale-oil. The year 2019 did not fulfil the potential anticipated. The global growth of oil consumption this year was below expectations, with no improvement to the oil surplus status in commercial oil stocks. The declared goal of the OPEC+ deal from its onset in 2017 was to create a state of deficit in oil markets, which in turn would lead to drawing from oil surpluses in commercial oil stocks.

OPEC issued a report that explained its long-term vision for oil markets. The report showed OPEC as accepting the idea that its market shares would fall back to increased production from outside the Organization, led by US shale-oil companies.

The report predicted that – amid OPEC's subsidizing of oil prices through the OPEC+ deal, besides other factors like enhancing efficient consumption, alternative energy sources, and electric vehicles – US shale-oil will continue its growth, taking over market shares, where it would reach 17 million/bpd by 2024, compared to 12 million/bpd in 2019. On the contrary, OPEC's market shares in oil production would drop from 35 million/bpd in 2019 to 32 million/bpd by 2024.

The International Energy Agency (IEA) confirmed OPEC's forecasts regarding the diminishing role of the Organization, adding that – given the current OPEC policies through the OPEC+ deal – Russia's market shares will also fall. The IEA also mentioned that the US will surpass Russia in both oil and gas production around 2025.

3. signs of a Russian-Saudi Disagreement on managing oil markets

The Russian-Saudi disagreement around oil markets gradually developed before the Coronavirus crisis.

In November 2019, Russian President Vladimir Putin spoke of a shared goal between OPEC and Russia; to make oil markets balanced and predictable. Forecasts then showed that Russia accepted extending the current OPEC+ deal, without further production cuts.

In December 2019, OPEC announced extending the OPEC+ deal with further cuts reaching 500 thousand/bpd. Markets did not react greatly to the production cuts announced by OPEC+, mainly due to fears of a trade competition, and also due to these production cuts having no effect on the situation in oil markets, since the deal stated that Saudi Arabia bears the greater part of these cuts at 400 thousand/bpd from a total of 500 thousand.

By 2020, Russia had achieved its biggest historical production rate of oil and condensate in 2019 at 11.25 million/bpd. Despite a crude oil cut at 240 thousand/bpd, Russia's production of condensate

continued to grow, which is a light oil that accompanies natural gas production. Russia did not submit official data detailing crude oil quantities compared to condensate, and Russian Energy Minister Alexander Novak hinted at the possibility of ending the OPEC+ without offering details.

With the beginning of the Coronavirus outbreak in China during February, information surfaced regarding OPEC's intentions to additionally cut production by 500 thousand/bpd. Russian officials had varied reactions, as Foreign Minister Sergey Lavrov welcomed the idea of further production cuts by OPEC+, while Energy Minister Novak was more conservative in his statements.

On March 1, 2020, Russian President Vladimir Putin stated that Russia accepted current oil prices (then at US$ 50 per barrel of Brent blend), and that further efforts to cut production were not feasible in the current circumstances. This was the first time that signs of a disagreement surfaced between Russia and Saudi Arabia regarding a joint vision regarding oil markets. Some analysts predicted that OPEC would resort to cutting production without Russia, meaning the end of the OPEC+ deal.

That has further disrupted markets, since in the past years of the OPEC+ deal, Russia usually refrained from giving a clear position regarding the deal's continuation except at the last minute, which is why oil markets were caught off-guard when the OPEC meeting failed in March 2020.

4. Failure of the Opec+ Meeting and the End of the Deal

The Russian-Saudi disagreement led to suspending the OPEC+ deal coinciding with the Coronavirus crisis, and oil prices dropped sharply.

In early March 2020, OPEC called upon Russia to take part in the efforts to cut production and support prices. OPEC presented a proposal – the highest since the global financial crisis of 2008 – to further cut production by 1.5 million/bpd until the end of 2020. The OPEC+ deal, in its context back then, stated cutting production by 2.1 million/bpd. OPEC's corridors were pessimistic, since non-OPEC countries wanted to curb cuts to 500 thousand/bpd only.

Calls for production cuts stated that Russia's share of additional cuts would be 300 thousand/bpd, bringing Russia's total contribution to the OPEC+ deal to total cuts of 600 thousand/bpd. The

persistent Saudi position following Russia's production cuts caused the OPEC talks to end on March 6, and oil prices saw a large fall (figure 1).

Saudi Arabia increased oil production and lowered prices, and a price competition began with Russia. Sources indicate that Saudi oil price reductions are the lowest since 2003, in a sign that these price reductions are not justified as a result for a fall in demand and economic conditions.

For example, Saudi Arabia lowered the oil price rate tied to the Dubai/Oman official standard from a US$ 2.90 raise to a US$ 3.10 discount. Regarding European shipments, light crude prices fell by US$ 8.00 to reach a discount of US$ 10.25 compared to the Brent standard. US shipments saw discounts of US$ 7.00, shifting Saudi oil price rates from an increase to a discount. Naturally, all oil exporting countries had to follow Saudi oil prices, which in turn led to further price declines.

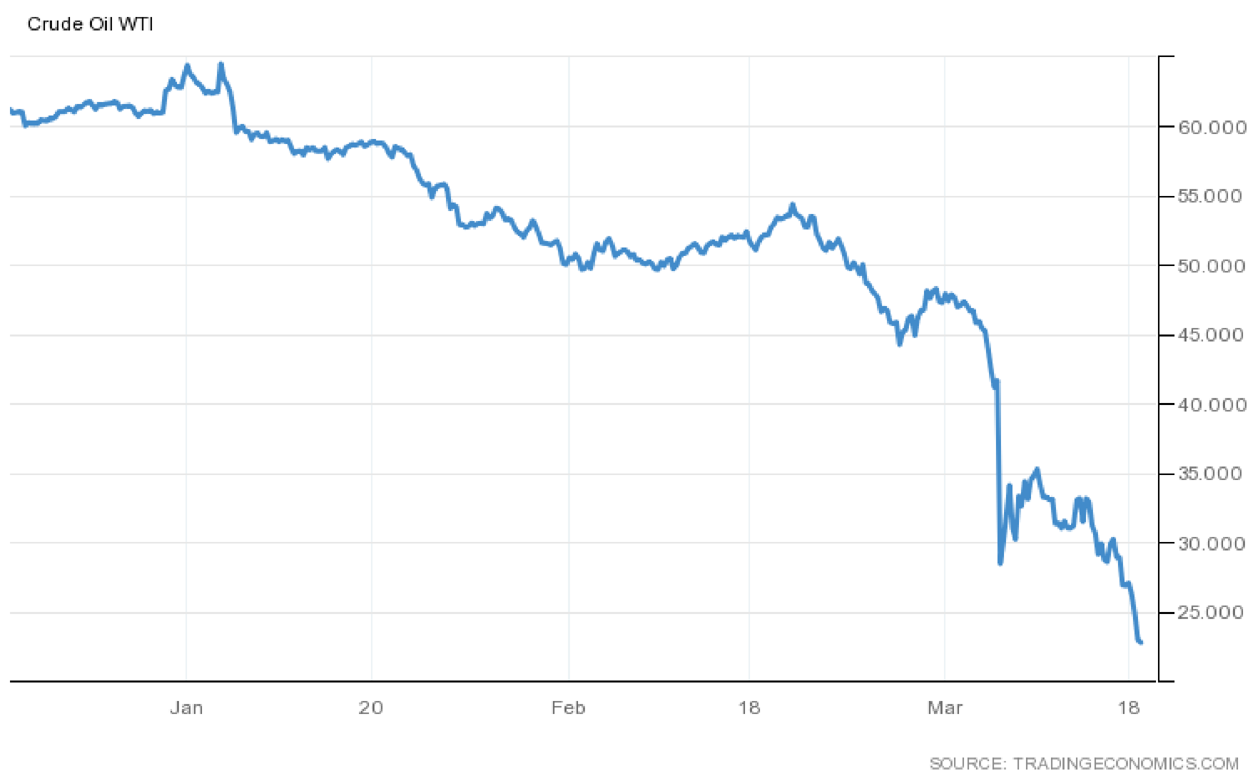

Figure 1: Oil prices during 2020

5. The Difficulty of Predicting Coronavirus Damages on Oil Markets

The impact of the Coronavirus crisis on oil prices will be sharp and temporary, but accurately estimating it is very difficult due to the crisis' complications, and the uncertainty of its course.

Since late 2019, there were signs of an economic slowdown, confirmed by the pessimistic tone of global oil companies, due to their expectations of reduced dividends to shareholders, such as Shell and British Petroleum. At the time, tensions from the US-China trade competition were the most prominent headlines moving the markets and predictions for the course of the economy.

With the dangers of the Coronavirus pandemic to the world economy, new variables have appeared for consideration. It is difficult to predetermine the duration and frequency of viral outbreaks, which influences how economic impacts of these outbreaks can be predicted and which in turn, depends on the type of epidemic and adequacy of the measures implemented to contain it, as well as death rates and society's reactions. Oil prices were quickly affected due to the 2020 price curve being different than the current one, which factors in a viral outbreak and a shutdown of global economic activities.

Oil traders strive to estimate the severity and extent of the impact on global consumption, resulting from the coronavirus outbreak in China, based on evidence from previous corona and flu viral outbreaks. As with any respiratory epidemic, the greatest impact hits the economy and oil consumption due to containment measures, like quarantine lockdowns and social distancing.

Governments were expected to implement some procedures to deal with public health emergencies, with companies voluntarily following suit, to limit exposure to the virus. Social distancing measures unsurprisingly had a high negative impact on consumer spending and the private sector, as well as manufacturing, providing services and transport networks.

In a course similar to that of the epidemic's spread, the economic impact tends to be sharp but not permanent, concentrated over a few weeks or months. The need for extreme quarantine and social distancing procedures is expected to recede, and economic activity will return to its normal level, after the period of outbreak and maximum infection is over.

With the epidemic vanishing, worries regarding health risks will eventually diminish, due to the mounting pressure to resume commercial activities. Companies, employees, transportation companies and schools will have to resume semi-normal activity to earn revenues, make money and pass exams. There is a possibility of remaining impacts on economic activity and oil consumption, until companies and families realize the loss of revenues and earnings from the first quarter of 2020, but this impact will disappear with time.

The coronavirus crisis disrupted oil transportation, since many shipments heading to China were forced to change course to other destinations. Oil refinery operations fell during the first two weeks of February by an average of 1.5 million/bpd, leading to Very Large Crude Carriers (VLCCs of 2 million barrels' capacity) to empty their loads in Chinese ports, while other shipments were diverted to South Korea, Malaysia and Singapore. With the decrease in refining activities, Chinese oil reserves have risen largely and quickly. Some sources estimate that China has oil storage facilities able to hold more than a billion barrels, and currently, oil reserves in China have reached 760 million barrels.

Some Russian officials speak of the unfeasibility of production cuts at present, due to the vague state of demand for oil and its continued fall, driven by the negative impacts of the coronavirus crisis. They demanded extending the OPEC+ deal for three months to assess the true impact of the outbreak on oil demand. The Russians expect price fall effects to start appearing on high-cost oil producers during the next 4 to 6 months, pointing to US shale-oil.

In February 2020, the International Energy Agency expected oil demand to fall in the first quarter of the year, to reach 1.3 million/bpd, with an overall fall in oil demand for the year 2020 of around 500 thousand/bpd, in a first decrease in demand since the 2008 global financial crisis.

Now, with the coronavirus spreading to most countries around the world, forecasts have shifted to extreme negativity regarding global oil demand amid this crisis. The latest forecasts vary in Q1 of 2020 between a fall of 4 to 10 million/bpd. These forecasts appear amid government regulations to counter the viral outbreak by restricting all sorts of movement for individuals, which in turn reflects on transportation, commercial and industrial activities. In general, 2020 forecasts expect oil demand to fall by 1 to 3 million/bpd.

6. US Reactions to these Developments

Oil prices will cause excessive damage to the US oil sector. However, there are limited instruments available to the US Government to persuade Saudi Arabia to change the current price course.

The falling oil prices that coincided with the coronavirus crisis caused a huge shock to American stock markets. In the beginning, US President Donald Trump commented on Twitter that these prices were good for consumers (March 9,2020), but he blamed the price competition between Saudi Arabia and Russia, in addition to what he called 'fake news' for causing a recession in American stock markets at the time; overlooking the effects of the coronavirus and global concerns of its implications. At the same time, the US Treasury Department issued a statement in which it accused global players of manipulating oil markets and causing shocks.

In the meantime, the Senate saw a move by Republican members, most notably by North Dakota Senator Kevin Cramer. Senators took several steps in order to alleviate the damage caused by the oil price competition between Russia and Saudi Arabia. On 18 March, Kramer sent a letter to the US president demanding that he puts a US ban on oil imports from Russia, Saudi Arabia and the rest of OPEC members. On the same day, some of these congress members had a phone call with the Saudi ambassador in Washington and expressed their desire for Saudi Arabia to change its current oil policy.

On March 20, an announcement was made to send a special US envoy from the Energy Department to Saudi Arabia. This special envoy is expected to stay in Riyadh for several months, and work there with officials from the US Department of State. This announcement saw comments from a Texas official, Ryan Sitton, who expressed his hope that President Trump would coordinate production cuts with Russia, Saudi Arabia and the state of Texas. This proposal for production cuts in Texas is considered the first of its kind in 50 years.

Sitton believed that cutting production in Texas would be easy, since there are state legislative mechanisms to do that. The Texan official's suggestion was welcomed by OPEC, whose Secretary General, Mohammed Barkindo, invited him to OPEC's next meeting in June.

However, the US energy sector is not fond of Sitton's movements, as officials from the American Petroleum Institute rejected the concept of limiting production, which Sitton proposed in an article to the Bloomberg website, suggesting that Texas contributes a 10% production cut, if Russia and Saudi Arabia implemented the same percentage cut to their production rates prior to the oil price competition. These efforts were not aimed at completely balancing the oil markets, but rather contributing to reduce the surpluses on offer. Sitton also demanded in his article that the US President takes part in negotiating this proposal with Russia and Saudi Arabia.

On March 24, the US President appointed Victoria Coates as Special Energy Envoy to Saudi Arabia. The next day, the Department of State announced that a better phone call took place between Secretary of State Mike Pompeo and Saudi Crown Prince Mohammed bin Salman Al Saud, in which they discussed the stability of oil markets, and the role of Saudi Arabia in the G20, as one of the most important countries for the stability of global energy markets. This phone call falls within the context of US efforts to persuade Saudi Arabia to change its current oil policy. It is believed that such US efforts aim to initially convince the Saudis to refrain from dumping excessive quantities of oil during April, as announced earlier.

Members of the Senate, among whom was Kevin Cramer, continued their demands in a letter to Secretary of State Pompeo, asking for a stricter position to counter what they called an economic war from Russia and Saudi Arabia against the United States. In this letter, senators proposed that Saudi Arabia completely abandons OPEC and avoids investment in the Russian energy sector, in return for the opportunity to contribute to joint energy projects in the United States.

Senators kept pushing, and senator Cramer presented a draft Bill (S.3572) to the Congress, calling for a withdrawal of troops and all US military equipment from Saudi Arabia within 90 days from the date passed, in an attempt to pressure Saudi Arabia to reverse its current oil policy.

Regarding the instruments currently at the US Government's disposal to deal with the fall in oil prices, the Congressional Research Service published a report that explains the policies available to the Congress to protect the oil sector under current conditions. These are summed up in the following: 1) Buying oil production through strategic reserves and enabling oil companies to pay their due taxes

using oil (Royalty-in-Kind). 2) Providing loans or collateral valued up to 500 million US dollars under Law (H.R.1664) from 1999, which supports oil production companies and their supporting sectors in such circumstances. 3) Implementing customs fees and restrictions on oil imports from OPEC, Russia and others. 4) Imposing sanctions on violators under terms of anti-dumping, with the feasibility of this course being uncertain.

The report concluded that these available federal instruments will find it difficult to correct the ailing market conditions, due to the coronavirus and its effect on destroying demand for all types of energy, and that there is no solution for oil markets except for all market-affecting factors to come together, starting with the recovery of demand to restoring production levels to where they were before the price competition. Despite all the aforementioned, uncertainty will continue regarding when markets are expected to recover.