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ANALYSIS

The day the oil markets crashed – again. Is this time different?

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Abstract

Absent a new OPEC+ deal on March 6 in Vienna, in the context of the coronavirus downfall, the crude oil price plummeted overnight to the low thirties a barrel. Apparently, Moscow was more interested in punishing the US shale oil producers, which have been major beneficiaries of the higher oil price following the first OPEC+ agreement in early 2017, than in renewing its deal with Riyadh.

To be sure, the OPEC+ deals were rather a matter of induced perception than real output cuts on the Russian side – a ''happy pro forma marriage", as put by Kruthikin and Overland (2020). Yet the effects were real, propelling the US to the top of the world's ranking of oil producers, with 13 mb/d in 2019.

It is highly uncertain that the new price war can bring long-term gains to Russia and Saudi Arabia. While the US shale industry is much more vulnerable this time around, and it will surely bleed, it will adapt and survive, albeit in an environment of lower oil prices. I estimate that, in a few months' time, oil demand will resume, bolstered by upcoming state aid packages in the US, EU and China, and that the Brent prices will again stabilize within a corridor of $40-60 a barrel – hence about $10 lower than the one of the past couple of years.

Whereas investment in renewables, electro-mobility and energy efficiency is likely to be delayed by the depressed oil prices, the ambitious regulatory framework of EU's climate policies can, nonetheless, create overarching economic incentives for green investment.

On March 7, the Brent global oil benchmark plummeted to $34.4 from $45.3 a barrel the day before, and $50 a barrel on March 5. The downfall brought the crude price close to the lowest level of the last two decades in a 32% drop that shell-shocked the oil industry around the world and slashed tens of billions from its market capitalization. A week of ups and down in the thirties-a-barrel territory has followed. At the time of this article's writing, on March 16, the Brent benchmark has fallen to $29.72 a barrel. It is not unlikely that the international oil benchmark will fall in the low twenties a barrel in the following weeks – and, occasionally, even under $20.

The oil market crash came right on the heels of an OPEC+ (i.e. OPEC and Russia) meeting gone wrong in Vienna, on March 6, in which Saudi Arabia and Russia failed to agree on an anticipated output cut of 1.5 million barrels a day (mb/d) until the end of 2020, on top of the 2.1mb/d cut agreed in December 2019. The oil production cut was supposed to address the demand slump caused by the coronavirus crisis, which had already sent the Brent price down from the high fifties a barrel in February to just under $50 a barrel before the market crash.

However, Russia reportedly lost interest in a new OPEC+ agreement, deeming it „meaningless," as it resulted in oil market share being steadily taken over by the American shale producers.

Apparently, Riyadh saw Moscow's action as a provocation and promptly announced a production ramp-up, first by 2.6mb/d to a total of 12.3mb/d, and a day later to the full capacity of 13mb/d. The fact that Saudi Arabia started with discounts of $8 a barrel for north-east European buyers, a key market for Russia, fed the perception that the current price cut came as a Saudi retribution for the Russian defection.

In several ways, the situation is reminiscent of late 2014, when OPEC failed in a similar meeting in Vienna to agree on a widely expected decision to curtail output, to deal with an oversupplied oil market. Back then, the Saudi leadership stunningly decided to open a commercial war against the ''unconventional" oil producers – mostly US shale companies, but also Canadian oil sands producers – that were steadily chipping away at the OPEC's market share.

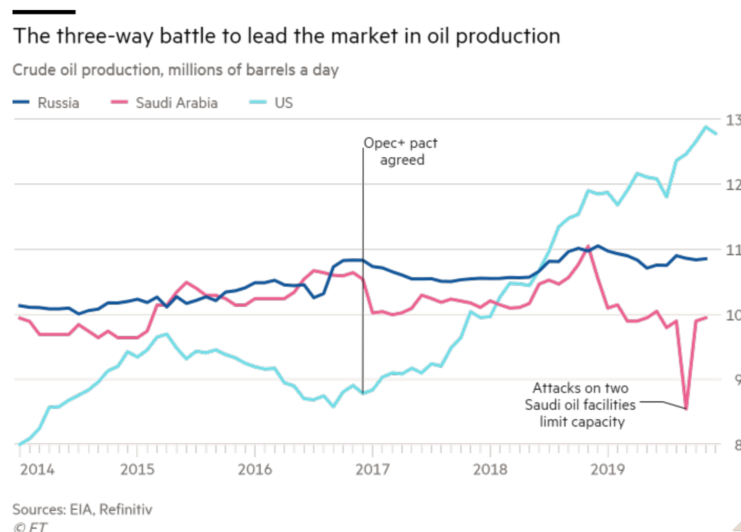
The crude prices collapsed in October 2014 and reached ever deeper levels. After a low point of $29.2 a barrel in January 2016, the Brent crude quotations started to pick up again in S2 2017, as an ostensible consequence of the first OPEC+ agreement. Many an oil firm, private and national, bled in that price war, which put an end to the age of Brent above $100 a barrel and kept them under $50 for more than two years.

In effect, since the end of the first half of 2017 the oil price enter a relatively stable corridor between $50 and $70 a barrel, with the low limit set through output control by OPEC+ and the upper one resulting from the increasing oil supply from the opportunistic shale producers, which can only thrive at higher barrel prices. As recently as January 2020, I was

maintaining, in a predictive analysis, that the $50-70 structural price corridor was going to hold for most of 2020, perhaps with some short-lived deviations.

But there was barely any energy market analyst to really see the coronavirus pandemic coming – and certainly not in its complex interplay with today's oil market fundamentals.

As shown in the graph below, done by the *Financial Times* (March 13), since the first OPEC+ production cut agreement came in force on January 1, 2017, while Russia and Saudi Arabia have kept relatively constant production levels – about 11mb/d for Russia and just above 10mb/d for Saudi Arabia – the US supply of crude increased steadily from less than 9mb/d at the end of 2016 to almost 13mb/d at the end of 2019.



Nevertheless, it is quite interesting to notice that Russia has not really cut down its oil production in all these years. As pointed out by Mikhail Krutikhin and Indra Overland,[1]

> *Russia's actual contribution to production cuts under the OPEC+ deal is dubious. Russia's oil output in 2017 amounted to 546.8mt (10,981mb/d), just 0.1 percent less than in 2016. Since 2016 was a leap year, Russia's average daily oil production actually grew slightly from 10,965mb/d to 10,981mb/d.*
>
> *In 2018, oil production in Russia accelerated, defying the Russian officials' declarations of solidarity with OPEC. During that year, Russia produced 555.84mt (11.45mb) of crude oil per day, 1.6 percent more than the previous year. This means that rather than falling below the October 2016 benchmark, as Russia has promised, its production in fact increased by 0.3 percent against that benchmark.* (p. 245)

Drawing on that analysis, the two authors are aptly calling the OPEC+ deal a *happy pro forma marriage*, very much aligned with the ''postmodern turn" in Moscow's foreign policy, as sold by Kremlin insiders such as Vladislav Surkov.

[1] Mikhail Krutikhin and Indra Overland (2020), OPEC and Russia: A Happy Pro Forma Marriage, in G. Garavini and D.H. Claes, *Handbook of OPEC and the Global Energy order*, Routledge, pp. 241-251

In any event, the mere psychological effects of the perceived OPEC+ collaboration have had pronounced market consequences. While OPEC and Russia benefited from a stable and relatively high crude price (and Russia, at least, kept pumping close to full capacity), another beneficiary of the higher prices was the US oil industry. While operating under strict anti-cartel regulations, the latter have become addicted to the OPEC+ cartelization that kept the global crude output under a lid.

To recollect, in 2015-2016, although aggressively targeted with price cuts, the US shale companies managed, taking great pains, to become vastly more cost-efficient, focusing on the most productive spots, economies of scale, renegotiating service contracts and issuing bonds that were eagerly bought by Wall Street.

These days, by contrast, the American shale oil producers are greatly indebted, their stocks in massive decline, and credit extensions much more difficult to obtain. As indicated by Oslo's Rystad Energy, at today's crude prices, capital spending would drop by 70% next year, and production would fall by 2mb/d. Of course, budgets will have to be slashed and rigs idled, and bankruptcies are highly likely.

For its part, Russia seems to be in a much better financial shape than in 2014, with foreign reserves totaling $570bn and a more self-reliant economy than five years ago. $150bn of those reserves are in the National Wealth Fund which, as indicated by the energy minister Alexander Novak,[2] benefitted a lot from the OPEC+ deal of 2017 on account of the higher oil prices.

With that war chest, Russia could withstand prices of $25-30 a barrel for up to a decade, according to the finance minister, Anton Siluanov, who estimated that average prices of $27 a barrel would require $20bn a year from the public budget. Moscow built its 2020 budget on a Brent price assumption of $47 a barrel, much lower than in 2015 and also much less than Riyadh's budgetary breakeven level of $83 a barrel in 2020. But, certainly, the economic fallout of the disastrous coronavirus turmoil could drastically change that calculation.

As a matter of fact, as argued by the *Financial Times*, the worst hits from the crude price crash will be taken OPEC members such as Iran, Algeria, Libya and Nigeria, whose budgetary breakeven levels are either just under or above $100 a barrel. The outlier is Iran, which would need no less than $195 a barrel to balance its public spending, but its oil exports are already drastically limited by US sanctions. Algeria would need $109, Libya $100, and Nigeria $95 a barrel. Even the richer Gulf states of Kuwait, UAE and Qatar will be affected, though they can rely on large financial buffers, while Iraq, OPEC second largest producer, could balance its spending at a Brent price of $70 a barrel.

These major oil producers, some of which have faced major social unrest in 2019, will have to tap into their foreign reserves, see their national currencies devalued, reduce public

[2] *Neftegaz.ru* (2018), Alexander Novak: OPEC+ Deal has brought Russia $120 billion

spending and increase the price of refined petroleum products to their consumers – something deeply unpopular across the entire OPEC world.

The low crude prices will hit hard the US shale companies and the Canadian oil sands producers, and Nigeria, Angola and Brazil are likely to face very serious economic slowdowns.

Russia and Saudi Arabia will lose a lot as well, and not just economically, but also geopolitically. The OPEC+ cooperation also brought Russia sizeable political influence in the Middle East, while the past couple of years of higher oil price offered a minimal stability to Venezuela's Maduro regime, Russia's ally, which is now facing total economic collapse.

It is, therefore, highly uncertain that the risky actions of Moscow (which was particularly annoyed with the idea of bailing out yet again the American shale industry just shortly after Washington imposed new sanctions on Rosneft) and Riyadh will turn out to be beneficial to them.

Yes, the US shale oil industry will pay a high price, but it will certainly not go extinct. It will again learn to operate in an even lower crude price environment – which, by the way, results in lower prices at the gas pump, as the Trump administration always wanted. Besides, it will very likely receive state aid in different forms in the context of the coronavirus crisis, such as low-interest loans from the federal government.

Moreover, as announced on March 14, the White House intends to purchase tens of millions of barrels of American-produced oil over the coming months, for the US Strategic Petroleum Reserve, using a safeguard against fuel shortages. As estimated by Rystad Energy, the move would add about 200,000 b/d of oil demand over the next quarter – significant, yet far from decisive.

Once the global economy will have resumed demand for demand, in a matter of months – indeed, the signs from China's relatively well performing stock market are encouraging, now that the covid-19 downturn seems to be receding domestically – oil demand is set to rebound. Nevertheless, it is hard to tell when and what the new price equilibrium corridor will be.

Bolstered by financial support packages expected in the US, EU and China, the markets will get over the current speculative shock – indeed, the price fall reached much deeper than the real demand cut over these past nine days. But a new stable price corridor is likely to set in a notch lower than in the past two-and-half years, between $40 and $60. This, we think, will be the new normal on the global oil markets for a few years, at least.

Meanwhile, the global oil industry will continue to be battered by the constraints of climate policies, divestment and lowering returns. True, a depressed oil price environment disincentivizes investment in renewable energy sources, electromobility and, alas, energy efficiency – a lesson well learned in the aftermath of the 2014 oil industry downturn.

Nonetheless, it will be especially instructive to see this fundamental market trend playing out in the EU, with the renewed ambition and far-reaching regulations of the European Green Deal, and massive redirecting of financial flows towards decarbonization.

For example, while the roll-out of electromobility can be delayed – although aggressive regulations may again rearrange the economic incentives – the switch from coal to gas in the electricity mix is likely to be accelerated. At the end of the day, though, in order for the European Green Deal to be financially sustainable, regulations must get the best out of the market trends, instead of denying them.