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# The Russian-Saudi oil standoff: Who will blink first?

By Angelo Katsoras

## Introduction

To say that the oil markets have been hit by a perfect storm may be the understatement of the year. First came the challenge of ever-tighter environmental regulations and concerns that demand could fall in the coming decades. Then the COVID-19 outbreak caused an immediate collapse in demand across many energy-intensive sectors, including trade and transportation. Last but not least, the oil-exporting alliance between two of the world's largest crude producers, Saudi Arabia and Russia, broke down over failure to reach an agreement on how to respond to the impact of the COVID-19 pandemic.

Saudi Arabia immediately reacted by ramping up production. Saudi Aramco, the national oil company, announced it would start exporting 12.3 million barrels per day (bpd) in April, a 26% increase over its level before talks collapsed. It has also begun offering discounts to various countries, including some of Russia's biggest customers in Europe.[1] In response, Russia responded by claiming it was considering raising production by a further 500,000 bpd in the near future.

Both sides are now locked in a war of attrition, each convinced the other side will back down first.

## How cooperation broke down

A previous agreement between OPEC and the non-members led by Russia to cut production by 2.1 million bpd was set to expire at the end of March. Saudi Arabia began pushing for both extending this agreement and cutting an additional1.5 million bpd in an effort to keep oil prices from tumbling further. Non-members, of which Russia is the largest producer by far, would have had to cut production by another 500,000 bpd. Russia refused to comply, putting an end to almost four years of cooperation with OPEC.

Truth be told, the partnership was on fragile footing from the beginning on account of their opposing worldviews. To cite but one example, in the Syrian civil war, Russia has thrown its weight behind Iran-backed President Bashar al-Assad, whereas Saudi Arabia had at one time been a major supporter of anti-Assad rebel forces and remains to this day a sworn enemy of Iran. Saudi Arabia also suspects Russia of not fully complying with recent oil production agreements.

## Why Russia opposes further cuts to oil production

Russia feels strongly that the support given to oil prices by past cuts not only benefited higher-cost U.S. shale oil producers financially, it allowed them to sell millions of additional barrels of oil on the global market while Russian companies were forced to restrain output. "We, yielding our own markets, remove cheap Arab and Russian oil from them to clear a place for expensive American oil," said Rosneft spokesperson Mikhail Leontiev.[2] By no longer artificially supporting oil prices, Russia hopes to weaken the finances of U.S. shale-oil producers and eventually take a good deal of U.S. capacity off line. It would also like payback for U.S. sanctions on its energy sector.

Another reason for Russia's opposition, reportedly, is that it feels further production cuts in this economic environment would not succeed in raising prices significantly. It would be much better, Russia argues, to focus on taking market share from other countries in order to be in a better position to benefit from the eventual rise in prices once the COVID-19 outbreak is brought under control.

## Which side is best equipped to win this game of chicken?

### *Russia: strong points*

Russia is entering this standoff with several strengths. For starters, it has $570 billion in foreign reserves and a debt-to-GDP ratio of only 15%. Even more importantly, Russia is able to balance its budget at an oil price of only $42 a barrel (almost half the price required by Saudi Arabia). Russia also claims it could withstand oil prices of $25 to $30 a barrel for six to 10 years.[3] Further, unlike Saudi Arabia, Russia has a floating currency. When the price of oil drops, so does its operating costs, particularly when measured in U.S. dollars.

[1] "Saudi-Russian price war sends oil and stock markets crashing," The Economist, March 9, 2019
[2] "Never mind punishing the US, Russia and Saudi Arabia's oil price war will hurt all producers," South China Morning Post, March 13, 2020
[3] "Russia says it can deal with pain of a Saudi oil price war," The Financial Times, March 9, 2020

Russia also has a geographical advantage over Saudi Arabia. It has pipelines that can deliver crude directly to refineries in Asia and Europe and shipping terminals that are only a few days' sailing from other refineries in these regions. In contrast, tankers leaving from Saudi Arabia take several weeks to reach major parts of both Asia and Europe. This adds to the kingdom's operating costs.[4]

## *Russia: weak points*

While Russia's finances are strong enough to endure a drop in oil prices, it does make it much harder to grow the economy and improve living standards. In fact, even before the collapse in oil prices and the spread of COVID-19, Russia had been plagued by sluggish growth and stagnant incomes. Russia's economic growth slipped from 5% annually at the start of the decade to only 1.3% in 2019,[5] while living standards picked up only marginally in the past two years after declining steadily since 2014.[6] In 2020, the combination of weak oil prices and the impact of the COVID-19 outbreak on Russia (147 cases so far) and its major trading partners is likely to tip Russia into a recession. Lastly, Russia must finance the costs of its actions in Syria and Crimea/Eastern Ukraine, which have left it subject to sanctions.

## *Saudi Arabia: strong points*

Like Russia, Saudi Arabia is entering this showdown with several strong points. It has foreign reserves of just over $500 billion and a debt-to-GDP ratio of 25%. Saudi Arabia also has the cheapest oil production costs in the world. The state-owned producer, Aramco, can produce oil for $2.80 a barrel, compared with over $20 for Russia's state-owned producer, Rosneft.[7]

Saudi is also virtually the only major oil producer with the ability to significantly raise oil production. This means that what it loses in price it can to a certain extent make up in volume.

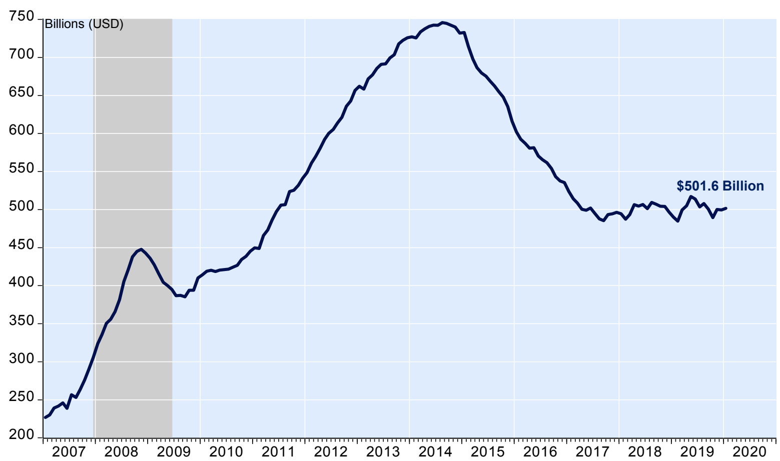
## *Saudi Arabia: weak points*

Saudi Arabia's most significant weak point is its massive spending. This includes extremely generous social programs, subsidized energy, highly paid government jobs, a proxy war with Iran, and efforts to transition away from an oil-based economy. Saudi Arabia also has one of the world's largest military budgets as a percentage of GDP at just under 9%. In stark contrast, the United States spends just over 3% of GDP on defence, while the figure for Russia is close to 4%.

The combination of these significant expenditures and low oil prices has already caused the country's reserves to plunge from a high of $730 billion in August 2014 to just over $500 billion today. Also, the country's public debt has shot up from less than 2% in 2014 to 25% today. While this debt level is still very low, the country's borrowing power is predicated on its reserves not falling to a dangerously low level. A significant drop in reserves could also threaten the riyal's peg to the dollar. All of this explains why Saudi Arabia needs oil to be at $83 a barrel to balance its budget, compared with only $42 for Russia.

On the economic front, even before the COVD-19 pandemic (171 confirmed cases in the kingdom) and the standoff with Russia, the country's GDP growth had declined from 2.2% in 2018 to 0.4% in 2019 (IMF).

**Saudi Arabia: Foreign reserves over the years**
Official international reserves (Standardized) (January 2020)




NBF Economics and Strategy (data via Datastream)

[4] "Saudi Arabia's oil crash has no quick end," Bloomberg, March 9, 2020
[5] "Russia seen weathering oil storm but growth, living standards under threat," Reuters, March 10, 2020
[6] "After Decline and Stagnation, Russian Income Growth Hits Six-Year High," Moscow Times, January 29, 2020
[7] "The Oil Price War Is Turning Into a Debt War," Bloomberg, March 8, 2020

Complicating matters even further, this standoff with Russia is taking place at a time of heightened internal political tensions in Saudi Arabia, highlighted by the recent arrests of senior royals in what many view as a move by Crown Prince Mohammed bin Salman to neutralize potential rivals.

## American shale oil production in cross hairs

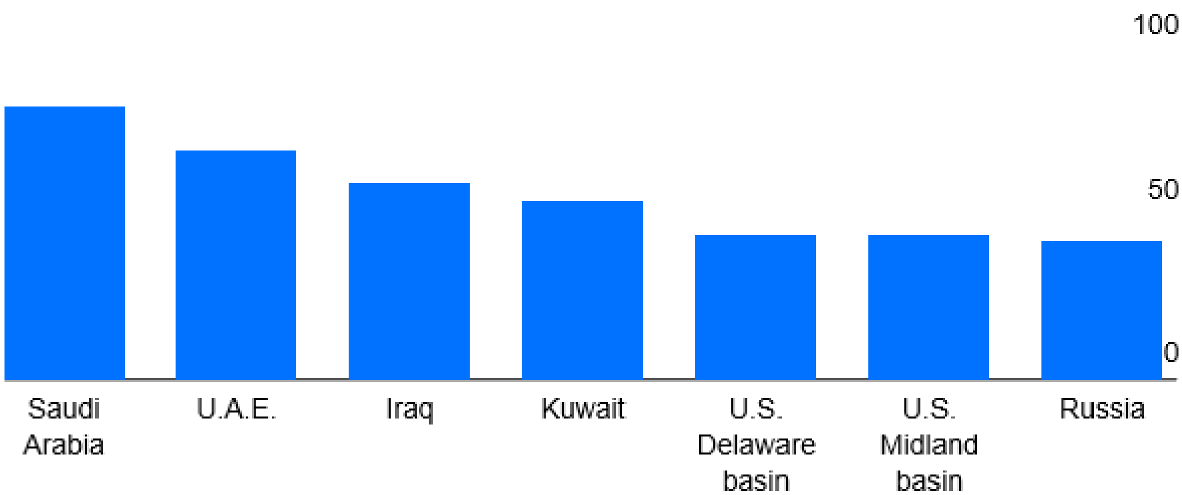
Back in 2014, Saudi Arabia and OPEC has sought to hurt U.S. shale oil producers by raising oil production. The attempt backfired. Despite the sharp drop in oil prices at the time, American companies managed to increase production thanks to efficiency gains and massive investment inflows.

This time around, the situation looks to be radically different, however. Above all, many investors have grown wary of the sector's lack of profitability and high debt levels, particularly among small- and medium-size companies.

It is important to note, though, that even if a larger number of companies were pushed into bankruptcy and production declined, the technology behind shale oil will remain. A significant recovery in oil prices would likely trigger an increase in production by large corporations and companies that emerge from bankruptcy with much lower debt loads.

Breaking Point

The level at which U.S. oil producers break even on their oil production is lower than that at which most exporters balance their budgets




Source: IMF, BTU Analytics, news reports
Note: Fiscal breakeven oil prices aren't the same as oil producer breakevens, but provide a good comparison for countries with national oil companies.

Source: "The Oil Price War Is Turning Into a Debt War," Bloomberg, March 8, 2020

## Conclusion

At the moment, Russia seems to have the edge over Saudi Arabia in this confrontation. Russia has greater reserves and has adjusted better to lower oil prices. Furthermore, Russia's economy is more diversified. Oil accounts for a whopping 70% of Saudi Arabia's revenue,[8] compared to only 25% for Russia (this jumps to 40% if you include natural gas).[9]

This said, regardless of who has the upper hand and notwithstanding reports that the two sides have resumed informal talks, we feel that it will be several months before either side gives in. Neither Russian President Vladimir Putin nor the Saudi Crown Prince wants to be perceived as weak. Both countries also have the financial cushion to absorb losses for several months before worries begin to emerge over the potential impact. However, beyond this approximate time period, mounting pressure on their finances will force the two countries to re-open serious negotiations that will ultimately lead to an agreement that will have both sides crying victory.

[8] IMF, September 2019
[9] "The Implications of an Oil Price Crash for Russia," Geopolitical Futures, March 12, 2020

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