



Takshashila Strategic Assessment

India and the Saudi-Russia Oil Price War

V1.0, 10 April 2020

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Executive Summary

Global oil prices have fallen by about half since early March 2020. On one hand the coronavirus pandemic is sweeping across the world, and on the other, the world is awash in oil because of the Saudi-Russia dispute over production cuts. While this stand-off on oil production will eventually be resolved, it is deeply tied to the domestic political priorities and foreign

policy objectives of both Russian President Vladimir Putin and Saudi Crown Prince Mohammed bin Salman. Despite the many international consequences, the oil price war offers India a narrow window of opportunity to build up its strategic petroleum reserves and lock in long-term supply contracts at attractive rates.

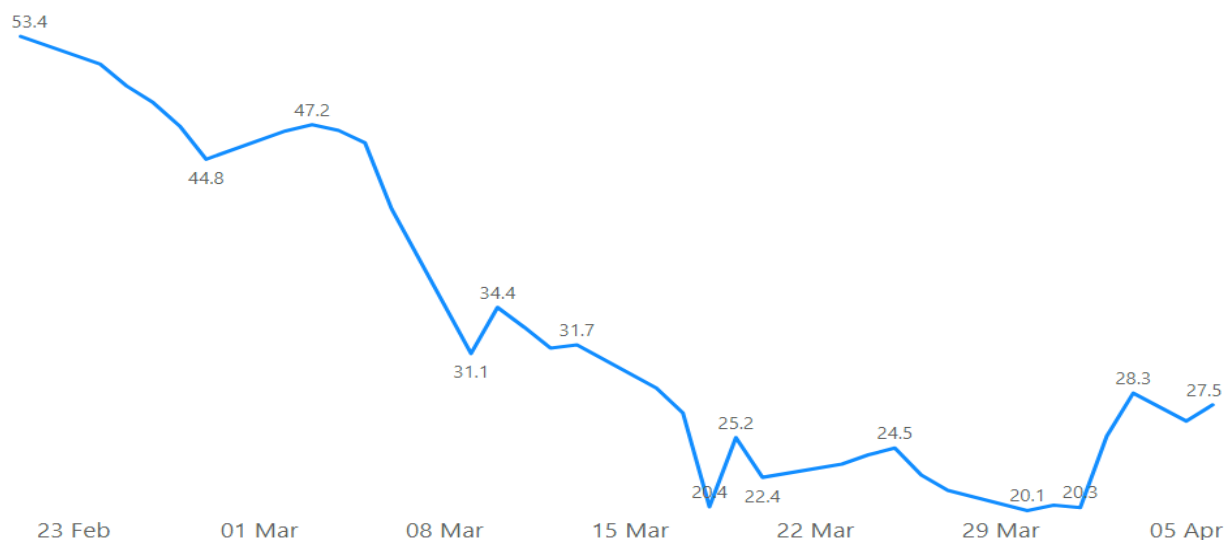
The Origins of the Price War

Both Russia and Saudi Arabia have immensely benefited from low prices as they expand their market shares and drive global competitors out of business. The origins of this price war trace back to the overproduction of crude oil combined with a plunge in demand because of the SARS-CoV-2 coronavirus pandemic have caused oil prices to fall by more than 50% since early March 2020. Global demand in April is [expected](#) to fall by 15 million barrels per day to 22 million barrels per day compared to the same period in 2019. On 01 April, Brent Crude was trading at \$14.85 per barrel and WTI was trading at \$20.31. The oil price war between Saudi Arabia and Russia began with a plan to slash production and maintain price stability. In early March, government officials from the 13 OPEC countries and 11 OPEC+ countries including Russia, met in Vienna to discuss their response to the global slowdown caused by the Covid-19 pandemic.

Members of OPEC insisted that Russia [join them](#) in cutting oil production. When Russia's energy minister, Alexander Novak, [abruptly left](#) after an initial meeting on March 5, OPEC responded quickly. With the Saudis urging maximum pressure, OPEC announced an initial production cut of one million barrels per day on the condition that non-OPEC partners (effectively Russia) account for [half the cuts](#).

Presented with this *fait accompli*, it became clear the Russians would not back down. Over the week that followed, the Saudis directed their state-controlled oil company Aramco to [hike production](#) from less than 9.7 million barrels per day to 12.3 million barrels [per day](#). Aramco even began [offering](#) deep discounts to traditional Russian markets like north-eastern Europe.

The breakdown in Saudi-Russian dialogue came only weeks before the expiry of a three-year deal between the two countries to coordinate [crude output](#). As of this writing in April 2020, the standoff continues despite some efforts to find a solution. Meanwhile, low oil prices take a toll on other OPEC [countries](#).



WTI Crude prices from late February 2020 - note the catastrophic fall after the breakdown of OPEC-Russia talks on the 6th, and the further drop after Saudi Arabia announced it'd be increasing production on the 8th. Data source: Investing.com¹

The Global Impact

The plunge in oil prices is having different effects on net producers and consumers of crude. One immediate consequence of the supply glut is the stress it has placed on the storage infrastructure. Scores of oil tankers are reportedly making circles at sea with no place to offload their oil. According to [one estimate](#), about 10% of the world's oil production is being kept in storage. The Saudis [have pre-positioned](#) oil in Egyptian storage facilities for sales in Europe and in March-end there were at least 16 very large crude carriers (VLCCs) parked at Saudi oil facilities, ready to be loaded.

While the Saudis will take a hit from low oil prices, other countries in the West Asia

are likely to see even bigger problems including [spikes in fiscal deficits](#). In late March, S&P Global Ratings [downgraded](#) the long-term credit ratings of Kuwait and Oman. Iraq plans to [hike production](#) in April by 200,000 barrels to 4.8 million barrels per day, but low prices will hurt its budgets. Other OPEC countries, which have higher costs of production, [are already feeling](#) the pain as they will lose both revenue and market share. Nigeria could see production fall by 35%. Venezuela is selling oil below production cost. Angola and Algeria plan to slash their public spending even as the Coronavirus pandemic spreads.

¹ Investing.com. "Crude Oil WTI Contract". https://in.investing.com/commodities/crude-oil-historical-data?end_date=1586143833&st_date=1581013800. Retrieved April 06, 2020.

U.S. shale oil, which needs a break-even price of about \$50 per barrel, is also taking a hit. Output is expected to drop in the third quarter along with investment in new wells, eventually slashing production by [at least](#) 2 million barrels a day from [the current](#) 7.7 million barrels per day.

As revenues fall, some American shale companies could also [struggle](#) to service debt incurred from earlier capital investments. Several shale oil and gas companies have already begun work on [restructuring debt](#) they raised through bonds.

With storage in [short supply](#), Canadian oil companies are also offloading their oil at prices well below \$10 a barrel, meaning that shipping costs often exceed the cost of the oil.

While most oil producers around the world are struggling, a few extremely low-cost producers continue to do profitable business. Most prominent among these is the Johan Sverdrup field off Norway's coast, which [could produce](#) oil for as little as \$2 per barrel once production ramps up by May.

Net oil consumers in Asia are also reaping gains. China, the world's largest importer of crude oil, has been [buying up](#) American shale oil at deeply discounted prices as

producers try to get rid of stock before storage runs out. Since Saudi Arabia and Russia are China's [top suppliers](#), cheap oil will place less stress on state finances amid the coronavirus-induced slowdown.

However, China's own state-run oil companies are [taking a hit](#) as consumers turn to cheaper overseas oil. These companies may have to shelve new products even as they retain their workforce to maintain social stability.



Russian President Vladimir Putin and Saudi crown prince Mohammed bin Salman meeting in Moscow in 2017.
Credit: Kremlin.ru

Motivations

Saudi Arabia and Russia are among the world's biggest producers of oil, [accounting for](#) 12% and 11% of global oil production respectively. Both have relatively low costs of production, approximately \$10 and \$20 per barrel for Saudi Arabia and Russia respectively.

Low production costs combined with the Saudis' ability to leave spare capacity idle for long periods of time have made the kingdom a swing producer - and given it enormous influence over the global price of oil at any time. It is this influence that has driven Russia's marriage of convenience with OPEC+, of which Saudi Arabia is the *de facto* leader. Though the

fall in prices due to the coronavirus pandemic is the ostensible reason for its departure from the group and the subsequent price war, tensions have been increasing in the last few years.

Struggling with the aftermath of US sanctions imposed in 2014, Russia's 2016 understanding with OPEC guaranteed it would be able to sell output reliably and at stable prices. This worked well for Russia: in 2019, its National Wealth Fund [doubled](#) its reserves from \$65 billion to \$124.4 billion. The Fund is the backbone of Russia's social security and pension systems, and thus an important source of

welfare that is crucial to maintaining President Putin's domestic popularity.

Meanwhile, global demand for energy continued to grow through 2016-2019, and oil prices remained high. This allowed non-OPEC members, such as the US, Mexico, Brazil and Norway, to enter the market. American shale companies were big winners, as the high prices offset their high production costs. Ramping up capacity with high capital expenditure, US production [briefly exceeded](#) Russia and Saudi Arabia in September 2019, with a [peak](#) of 13 million barrels per day.

Another cause of tension in OPEC+ has been direct competition between the Russians and Saudis themselves. Over the course of 2018-2019, both attempted [to capture](#) the market share that Iran was forced to vacate by US sanctions. The two also competed over energy markets in Asia - Russia, for example, moved rapidly to guarantee oil to India and other countries after the attack on Saudi oilfields at Abaiq-Khuraib in September 2019.

Based on this, it is possible to discern some explanations for the price war.

The first is that the Saudis continue to seek price stability and want the Russians to take on their fair share of the production cuts. This is not something Russia is willing to do - unless other countries, such as the US, also agree to cuts - something over which the Saudis have little control. Riyadh might be attempting to use economic coercion against Moscow by letting prices crash,

forcing them to agree to cut production for price stability.

The second explanation is that, notwithstanding their antagonisms, both Riyadh and Moscow have a shared interest in using low oil prices to wipe out rivals with higher production costs and thereby increase their own market shares. This motive is [especially apparent](#) with American shale oil, which has emerged as a major competitor over the last decade but has much higher break-even production costs than the Saudis and Russians.

The third explanation is that the Saudis under Mohammed bin Salman are [preparing for a post-oil future](#). The Saudis expect renewable and new forms of transportation like electric cars to gain traction in the coming decades and want to sell as much of their oil as possible while consumers still want it. Rather than charge high prices now and be stuck with oil reserves that no one wants by the middle of the 21st-century, the Saudis are determined to increase their market share and accumulate the wealth needed to invest in a future economy. Evidence of this can be seen not only in the ambitious projects of bin Salman such as the planned futuristic city Neom but also in his attempts to fundamentally reshape the national oil company, Saudi Aramco. The last few years have seen Aramco float an IPO (that was nowhere as successful as previously hoped) and focus on value addition by adding [refining capacity](#) and entering [associated industries](#) like chemicals.

The fourth explanation for the oil price war looks to the [personalities](#) of bin Salman and Putin. The Saudi crown prince has often been perceived as being bolder and more impulsive than the typically cautious Saudi rulers of the past. In this explanation, bin Salman entered into a price war without much forethought. Given that both he and Putin have reputations to maintain as strong leaders, neither was able to back down immediately.

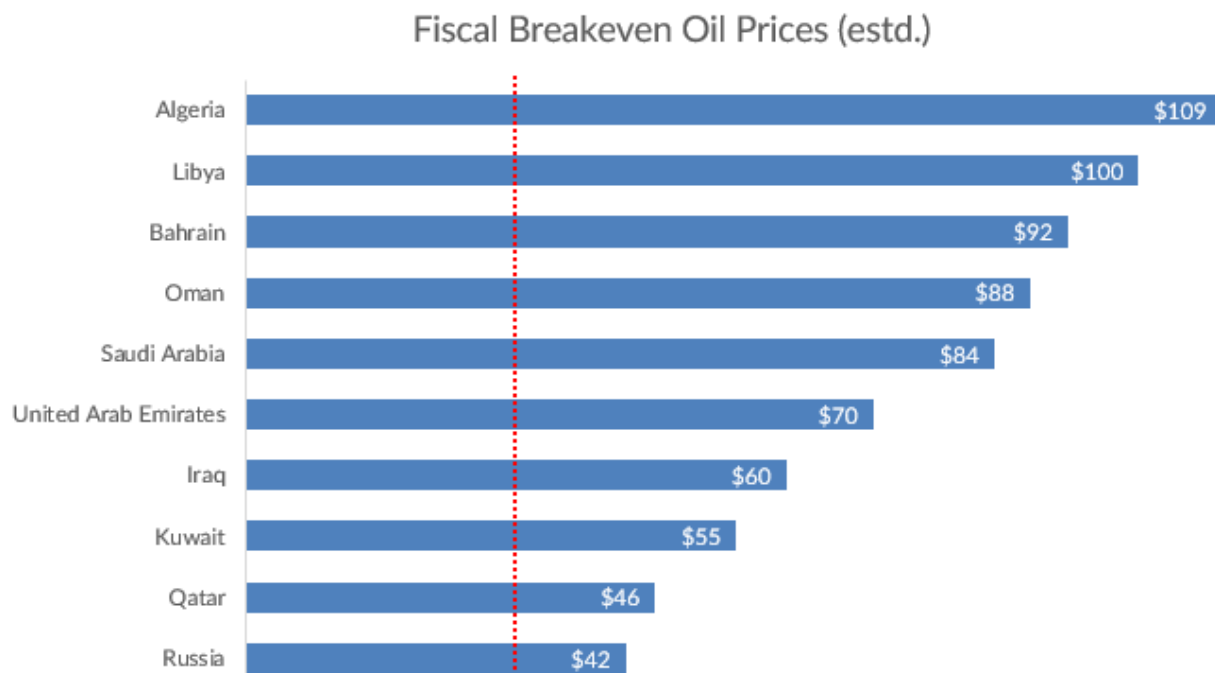
None of these explanations are mutually exclusive and all four go some way in explaining not only why the Russians and Saudis began the price war but also why they persisted and how they may be resolved.

Finally, it is worth noting that while Riyadh had many reasons to engage in a price war, this comes with many costs. Most notably, while the Saudis have low production costs, their fiscal break-even price for oil is [about](#) \$80 per barrel (the exact amount depends on much they sell). Also, the Saudis' own OPEC partners, especially neighbours like the UAE, Kuwait and

Oman, are being hurt. It is not in Riyadh's interests to alienate its fellow Gulf monarchies.

Another key partner the Saudis risk alienating is the United States. While bin Salman may be happy to see shale producers take a hit, he cannot afford to alienate the mercantilist administration of US President Donald Trump. All these are good reasons for the Saudis to find an accommodation with Russia.

On the other hand, Russia has among the lowest fiscal breakeven prices for oil in the world, around \$40, and a social security net that will allow it to bear a shock. Russia does not face the same geopolitical constraints as Saudi Arabia and is far more invested in wiping out US shale and other minor competitors. It is unlikely to return to the negotiating table unless it starts to face economic and political costs. The spread of Covid-19 will be a big factor in this decision, but its costs will only become evident in the medium term.



The red line indicates the price of Brent crude as of March 25th, 2020. Both Russia and Saudi Arabia can sustain a price war in the short-to-medium term, but many other producers cannot. Data source: Reuters², International Monetary Fund³.

The Impact on India

A fall in oil or commodity prices always benefits India. In 2017, India consumed about 4.34 million barrels per day, of which nearly 80% was imported. A fall in oil prices has significant implications on India's macroeconomy. Firstly, it would result in a significant reduction in India's import bill and would ease the pressure on its trade balance. Every dollar increase in the price of oil increases India's import bill by ₹10,700 crore on an annualised basis. Second, a change in the price of oil has implications for India's inflation rate. For instance, for wholesale prices, the weight

of all crude related products is around 10.4%, which implies that a 10% increase in crude price can potentially lead to 1% increase in Wholesale Price Index (WPI) inflation. For consumer prices, the weightage is smaller, at 2.4%, but the passthrough occurs to all other goods and services.

Finally, the price of oil is also important to the union government in terms of both expenditure and revenue. In terms of expenditure, the government's subsidy bill decreases based on crude prices. A

² Davide Barbuscia, Darya Korsunskaya. "Russia vs Saudi: How much pain can they take in oil price war?" Reuters. March 9, 2020. <https://www.reuters.com/article/us-opec-oil-policies/russia-vs-saudi-how-much-pain-can-they-take-in-oil-price-war-idUSKBN20W21S> Retrieved March 25, 2020.

³ IMF Data. "Breakeven Oil Prices". 2018. <https://data.imf.org/regular.aspx?key=60214246>

\$10/barrel increase in oil prices [also increases](#) the annual subsidy expenditure by the union government on kerosene and cooking gas by ₹18,400 crores, as of 2018. On the revenue side, the net effect of higher tax due to increased demand and lower tax collection due to decreased prices has to be worked out.

However, many of these calculations do not necessarily hold up amid a pandemic that has fundamentally changed the economic landscape. A decrease in oil prices will still have a downward pressure on India's import bill, but in the overall scheme, this effect will be marginal. As the country goes into a lockdown mode, the demand for petrol and diesel has reduced

Near-Term Prospects

Production of oil will have to be scaled back in the very near future. The world is likely to [run out](#) of storage space in the coming months. Also, if high rates of production and low prices persist over a longer period, it will create a correction of its own by knocking out producers like US shale from the market, thus reducing overall global output.

There are broadly three ways in which the oil price war could end. One, there could be unilateral or uncoordinated price cuts as some producers decide to quietly scale back output to protect their own interests. Two, there could be a coordinated production cut within OPEC or between

significantly, irrespective of the price. Similarly, this time, there are far more pressing variables that will influence the inflation rate, rather than oil prices. When there is a simultaneous demand slump and a supply chain crisis, oil prices may not play an important role in determining inflation rates. On the government's balance sheet, the subsidy bill might come down due to the lower prices, but revenue will fall even sharply. When the overall economic activity comes to a grinding halt, the demand and subsequent consumption of oil products will fall drastically. This results in lower tax revenue for the government.

OPEC and Russia. The third possibility is a broader deal that involves not just OPEC but also the United States.

There are obstacles to making such a deal, not least of which is that U.S. law [explicitly prohibits](#) it. Any such outcome would also reshape global oil markets in ways that may not be in India's interests.

As of this writing, the U.S. is pushing Riyadh and Moscow towards a deal. However, regardless of how the oil price war ends (or gradually winds down), India must take advantage of low oil prices while they last.



Indian Oil Refinery. Credit: [Wikimedia Commons CC BY-SA 4.0](#)

Recommendations

Under normal circumstances, absent a global pandemic, the union government would have to decide how to utilise the increased fiscal space it has because of low oil prices. In the present circumstances, however, cheap oil will not build a fiscal cushion since demand is low. And the government is constrained in its policy choices as it focuses on dealing with the pandemic and its fallout. The only advantage that the Indian government can take is to fill up its Strategic Petroleum Reserves (SPR).

SPR refers to the holding of oil inventories or stockpiles to help maintain national security during an energy crisis. India has

roughly five days of oil import cover [stored in underground salt caverns](#) and another 65 days of import cover held by commercial refineries. Commercial refineries, many of which are public sector companies, should also be focusing on entering into and renegotiating long term contracts with suppliers based on the lower prices at the moment.

Both private commercial oil enterprises and government agencies operate India's underground reserves. Given the overabundance of oil, the government agency, Indian Strategic Petroleum Reserves Limited (ISPRL), should be strategically focusing on filling up its share

of SPR. Indeed, every time the price of Brent crude oil falls below \$45 per barrel, ISPR should consider filling up the SPR.

The second phase of the SPR, which is being built on a PPP model with either Abu Dhabi National Oil Corporation (ADNOC) or Saudi ARAMCO, should also be fast tracked into operation this year.

Further, as part of its SPR diversification strategy, India should now think of diversifying its SPR portfolio on a geographic basis as well. For example, Abu Dhabi or Fujairah in the UAE can be contracted by India to hold a certain amount of oil on behalf of India. As part of the agreement, this can be mobilised and released to India as needed.

Apart from the SPR, the union government can also consider giving a fillip to India's struggling airline industry while oil prices are low. It can do this by encouraging long-term contracts with oil suppliers and locking in the attractive prices on offer at this moment. The airline industry has been struggling in India for some time, as evidenced by the fall of Jet Airways last year. If an airline doesn't have the financial health to seal such deals, the union government can provide lines of credit through the State Bank of India, or otherwise help in financing. This could help the airline industry in recovering faster when lockdowns eventually ease.