Crude Oil

9 March 2020

$30 oil NOT impossible after OPEC+ fiasco

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- **Following the fallout in relations between Russia and OPEC last Friday, we see downside for Brent as low as $30/bbl.**
- **Although Russia has a higher marginal cost of oil production than Saudi Arabia, it has budgeted a fiscal breakeven of $42/bbl – almost half that of Saudi Arabia's $83/bbl.**
- **This has allowed Russia to beat Saudi Arabia at its own game, despite being strong-armed by OPEC to cut production leading up to last Friday's OPEC+ meeting.**
- **The average cost of production in OPEC is about $30/bbl, which is where we expect Brent prices to fall to in the short-term.**

- **Recap: Russia walked away from being strong-armed by OPEC into cutting oil production.** OPEC+ met in February in an emergency meeting to discuss further production cuts in light of the coronavirus outbreak (then just confined largely to China). A proposed 600kbpd cut fell flat as Russia opted against that decision.

- **Perhaps frustrated by Russia's recent lack of cooperation**, leading up to the March meeting, OPEC did an unusual step of unilaterally discussing how much to cut production across OPEC+ before submitting the proposal to Russia for review. This was a high stake strategy that was, in essence, attempting to limit Russia's options at the negotiation table.

- **Russia, however, beat Saudi Arabia at its own game**. Scarred by the collapse in prices during 2014-15's shale boom, in which the Russian economy endured a recession, Russia has been consistently budgeting a lower fiscal breakeven oil price while diversifying its economy to other sources of non-oil revenue.

- **The result is a lower fiscal breakeven oil price for Russia than Saudi Arabia**. Russia's 2020 fiscal breakeven oil price is budgeted at $42/bbl from more than $100/bbl pre-2015. Saudi Arabia, on the hand, has a fiscal breakeven price (almost) twice that of Russia's, at $83/bbl. That is to say, Russia can still meet its fiscal balances even if Brent prices fall to $43/bbl, even though it has a much higher marginal cost of production ($20-$50/bbl) compared to Saudi Arabia ($9-$22/bbl).

- **There might also have been an element of vengeance from Russia**. When US shale oil flooded the markets in 2014, the Russian economy went into recession into 2015. The economy contracted almost 3% that year while the ruble depreciated to 78.7 per dollar from less than 50 a year ago. After five years of diversifying dependence on oil revenue, Russia now deals the same economic blow back to US shale producers.

- **Russia's backing out means the supply curbs since 2019 are set to end.** More than 2mbpd of supply cuts across OPEC+ have been in place since 1 Jan 2019, as members consistently reduce output to cope with the US-China trade war impact on oil prices. Russian Energy Minister Alexander Novak now says that Russia is free to produce what they want once the current supply curb arrangements end on 31 March 2020. In retaliation, Saudi Arabia says they will raise their production from its current 9.7mbpd to more than 12mbpd.

- **With the two biggest oil producing members backing out of the supply cuts, other OPEC+ members are almost certain to follow.** This means the reduction of the 2.1mbpd oil supply since 2019 will return to the market almost overnight beginning 1 April 2020, as members all scramble for market share.

- **The Betrand economic model of competition suggests prices will fall to the lower cost of production.** This level appears to be $30/bbl, which is the average cost of production in OPEC.

- **Where to from here? In the best case scenario, a truce is called after a relatively short production war.** Prices briefly plummet to $30/bbl (<3 months) but quickly recover above $50/bbl as Russia and Saudi Arabia calls for a truce. Supply across OPEC+ is once again reduced by 2mbpd and this coincides with a possible subsiding of coronavirus concerns.

- **In a more pessimistic scenario, prices remain around $30/bbl for an extended period (> 12 months).** Russia and Saudi Arabia floods the market with crude oil while the coronavirus situation takes longer than expected to abate. Prices start to correct as demand-supply forces balance themselves but that will take time, possibly a year or more.

- **There will be implications for the O&G sector in the worst case scenario.** Oil exploration projects will go belly-up as it becomes unprofitable to conduct oil exploration at such depressed prices. Many O&G companies are expected to go into bankruptcy or receivership and defaults on loans are expected, not unlike what was observed in 2015. US shale producers, which reportedly have one of the highest marginal costs of production, will exit the market, resulting in lower US share of the oil market.

- **Expect global deflation if oil prices stay at $30/bbl for an extended period of time.** Oil prices play a crucial role in direct inflation inputs and have secondary effects in the costs of productions in almost all goods and services. Oil at $30/bbl is almost certain to push inflation in developed countries, which are already struggling with very low inflation rates, into negative territory. This will have an impact on monetary policy, as policy makers see the space and impetus to further loosen monetary policy as they try to keep prices from spiralling into an uncontrollable deflationary cycle.

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