The Saudi Arabia-Russia oil war, explained

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March 9, 2020

A long-standing deal between Saudi Arabia and Russia — two of the world's oil-producing powerhouses — fell through over the weekend, sending global markets into a spiral and dashing future economic prospects in the US.

And it has almost everything to do with the coronavirus — or, more specifically, the drop in Asia's oil consumption that's being driven by the coronavirus outbreak there.

Last week, members of the Organization of the Petroleum Exporting Countries (OPEC), a cartel of 15 countries of oil-producing nations, met at OPEC's headquarters in Vienna to discuss what to do as the disease's impact has lowered global demand for oil.

Russia is not part of the bloc, but Russian officials were invited to the meeting. That's because three years ago Russia made a deal to coordinate its production levels with the group, in a pact known as OPEC+.

At last week's meeting, Saudi Arabia, the cartel's leader, suggested the participants collectively cut their oil production by about 1 million barrels per day, with Russia making the most dramatic cut of around 500,000 barrels a day. Doing so would keep oil prices higher, which would bring in more revenue for nations in the bloc whose economies are heavily dependent on crude exports.

Riyadh considered the move necessary as Asia, which is roiling from thousands of cases of coronavirus mainly in China and South Korea, no longer consumes as much energy as it did only a few months ago. China's refineries, for example, cut their imports of foreign oil by about 20 percent last month. Lower demand leads to a drop in the commodity's price, which thus hurts countries' bottom lines.

The Russians, wary of such a move for weeks, opted against the plan. It's still unclear exactly why that's the case. Some say Russia wants prices to stay low to hurt the American shale oil industry or is gearing up to seize a bigger sliver of Asian and global oil demand for itself.

"The Russians are more worried about market share and think they'd do better competing with the Saudis rather than cooperating at this point," says Emma Ashford, an expert on petrostates at the CATO Institute in Washington.

Saudi Arabia didn't take too kindly to the Kremlin's decision and responded by slashing its export prices over the weekend to start a price war with Russia. That brought the price per barrel down by about $11 to $35 a barrel — the biggest one-day drop since 1991.The upshot of that decision is the Saudis have positioned themselves to snatch what's left of Asian oil demand by having a cheaper product to sell, aided by very low production costs per barrel. But there's a big downside: The price for oil is a global one. If the Saudis tank it, as they just have, it goes down pretty much everywhere.

Dwindling revenues mean global energy companies — including smaller shale-producing firms in Texas and the Dakotas — make less profit. That's spooked markets around the world, with shares in Tokyo dropping 5 percent and a top index on Wall Street falling by 7 percent, forcing a trading stop shortly after open on Monday.

President Donald Trump is unhappy with the news, of course, as a growing economy and a strong stock market are some of his best cases for reelection in November. But he simultaneously seems happy that lower oil prices mean prices at the gas pump in the US will also go down, which could potentially strengthen his electoral chances.

Few can predict what will happen next, especially since it's unclear what further effects the coronavirus may have on the global economy. What is clear, though, is that lower demand for oil and longer-term trends in the energy market have ruptured the tepid Saudi-Russia alliance for now — and the consequences will be felt everywhere, including in the United States.

"At this point, it's every country for themselves," Emily Meierding, a Naval Postgraduate School expert on international oil cooperation, told me.

The recent global energy market, very briefly explained

In 2014, the US boomed onto the scene with its revolution in shale energy, capturing a greater and greater slice of the global oil market. In just seven years, US shale oil production grew to over 4 million barrels a day from around 0.4 million barrels a day.

That stunning rise completely upended the years-long dynamic in which the US was mostly an energy importer, not exporter. Instead of paying Saudi Arabia and Russia for their oil, America was now a serious competitor.

"For the next 50 years, we can expect to reap the benefits of the shale revolution," Harold Hamm, a pioneer in the discovery of shale oil, told the Guardian at the time. "It's the biggest thing that ever happened to America."

Naturally, the Saudis and Russians, the world's two largest oil exporters at the time, weren't pleased.

The Saudis through OPEC responded later that year — not by cutting production to keep prices higher, but rather by flooding the market with oil. With its billions of dollars in foreign exchange reserves, the Saudis knew they could withstand the drop in profits in service of the long-term goal: plunging prices so low that the nascent American industry would go out of business. Despite being asked by the Saudis, Russia didn't really cut its production — leaving Saudi Arabia to shoulder the burden.

The US shale industry persisted, though, and continued to gain strength. Riyadh's plan backfired. Between America's growing exports and Saudi Arabia's overproduction, there was a glut of oil for sale and the price continued to plummet.

Saudi Arabia and Russia survived their change in fortunes by selling cheaper oil to China, which desperately needed priced-down crude during its economic slowdown of 2015 and 2016. That made the exporters even more reliant on their prominent Chinese customer.

They still had to contend with their America problem, though. In 2016, Saudi Arabia and Russia agreed to cooperate in the world oil market by coordinating their production. Ashford, CATO's petrostates expert, told me that by themselves those countries couldn't swing global oil prices. Together, they could.

Between 2017 and now, Meierding told me, Saudi-led OPEC cut its oil output by 4 to 5 million barrels per day. That didn't really lead to a hike in price, though, because the US shale industry kept producing and exporting oil.

That trend continued as the US surpassed both Saudi Arabia and Russia as the world's leading crude producer in 2018. It gave Washington way more power over the energy market and future revenues for Riyadh and Moscow.

Still, the Riyadh-Moscow alliance continued, as there were no major disruptions to the energy market — that is, until coronavirus led demand for oil in Asia to tank. That gave both Saudi Arabia and Russia a choice: continue in their pact, or try to fend for themselves in a more competitive marketplace.

The events of this past week — Russia's split from the pact and Saudi's retaliation — make crystal clear the path each side has chosen.

"Who will blink first?"

To say that the Saudi-Russia spat was a surprise would be an understatement. "People have been expecting this kind of break for a while," the Naval Postgraduate School's Meierding told me, "but no one expected this to be such a dramatic break."

It's why experts are split on the real reason for why this happened. But two schools of thought — which aren't mutually exclusive — have emerged.

The first is that Russia wants prices lowered — not propped up via its Saudi deal — to hurt the American shale industry. The immediate results seem promising, if that is the Kremlin's true intention. Stocks for smaller to mid-size US shale companies are in free fall now, with the valuation for some dropping as much as 45 percent in recent days. This would also be a way for Russia to get back at the US for sanctioning its major energy company, Rosneft, for its deals with Venezuela last month.

And there are reports indicating the US shale market was at least part of the reason why Russia walked away from the OPEC plan, as Russian President Vladimir Putin seems to think that working together to keep oil prices high would only help America. Now Moscow needs a new way forward — and it doesn't involve cooperating with the Saudis, it involves competing against both them and the US.

But some experts are skeptical this was Russia's true or primary motivation. They told me if smaller US companies go bust during this time, bigger American firms like ExxonMobil will just buy their assets. There will be more consolidation — fewer companies in the shale oil industry, perhaps — but America’s production won’t go away. Russia’s play, then, would be doomed to fail.

Which leads to the second and more convincing theory: that Russia decided to make a play for more power in the global oil market. It couldn’t do that by agreeing once in a while to cut production with the Saudis. After all, Russian firms still make money if those companies export in even at a time of low prices. The profit margin will be thinner, but they’ll still gain customers and some revenue.

“It’s all about regaining market share,” says Meierding, and both countries are now in a price and production war.

The problem is that Russia’s play and the Saudi response may end up hurting them both. Shares in their national oil companies — Rosneft and Saudi Aramco, respectively — have already dropped. And unlike in 2015-2016 during which China bought up a lot of oil during a period of low prices, there aren’t really any buyers like that to pick up the slack right now, as demand is dropping worldwide, Ellen Wald, an oil market expert at the Atlantic Council think tank in Washington, told me.

That makes Russia’s decision likely an ill-advised one. It’s going to lose revenue in its bid to compete with America while not necessarily gaining strength in the energy marketplace. Saudi Arabia is hoping that lowering prices, which also hurts its own bottom line, will get Moscow to realize that and start cooperating again.

The question now, Wald says, is: “Who will blink first?”