Saudi Arabia Sparks Oil Price War – Implications For The Tanker Market

Over the weekend, Saudi Aramco sent shockwaves through global markets as it announced steep discounts to its official selling price for April, igniting a price war among major global producers. Consequently, oil prices are down significantly. At the time of writing, WTI and Brent prices are in the low to mid $30s per barrel, down 25% and 24% respectively. The turmoil in the oil markets, coming amidst the continued spread of the coronavirus, also spooked the stock markets worldwide.

What happened?

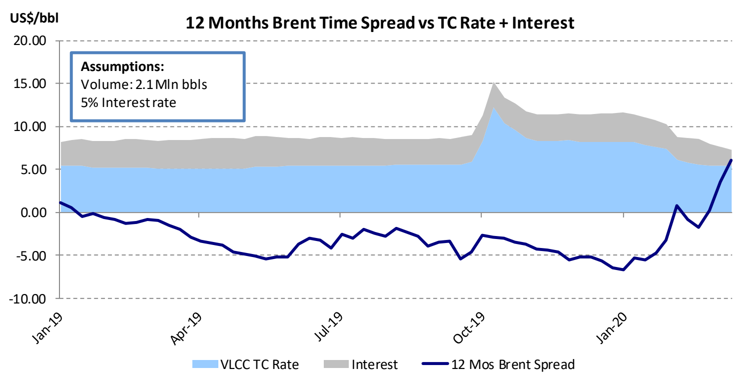
Saudi Arabia's decision to cut prices comes as negotiations between OPEC producers and non-OPEC allies, an alliance often referred to as OPEC+, failed to reach an agreement on deeper production cuts in response to weakening global demand. OPEC had recommended cutting production by an additional 1.5 Mb/d, starting in April and continuing until year end as the impact of coronavirus continues to slow global economies. However, OPEC's main ally Russia rejected the proposal, fracturing a three-year alliance that had successfully stopped a price crash in 2016. Russia seems to believe that an additional production cut will mostly benefit North American shale producers. On the other hand, OPEC's kingpin producer Saudi Arabia seems unwilling to deepen production without Russia's participation. The current OPEC+ deal is set to expire this month, after which global producers have the option to raise their output to try to gain market share. While many of the OPEC+ producers are maxed out, both Saudi Arabia and Russia have the capacity to increase output. It is difficult to understand the rationale of what happened during the last 3-4 days. Being able to produce 5% more at a price that is 20% lower does not seem to be a great deal, but that seems to be the reality facing producers now.

What will happen next?

- It is impossible to say what will happen next. Is Saudi Arabia trying to bring Russia back to the negotiating table? Are the Russians really going after U.S. shale producers? What will happen to the fragile economies of some of the other OPEC producers? Countries like Venezuela and Iran, some of which are geopolitical allies of Russia, can ill afford significantly lower prices.

How will the tanker market react?

- **Short term (<3 months)**: Increasing oil supply at significantly lower prices in a market with weak demand fundamentals should lead to an increase in demand for floating storage. That is indeed happening. We are seeing several deals being negotiated for short-term (6-12 months) charters, with one already concluded. The fall in oil prices has made floating storage more attractive, although the margins are still relatively thin (see chart)



- **Medium term (3-6 months)**: If oil prices remain low because both OPEC and non-OPEC producers are increasing output in an attempt to gain market share in a market that is still affected by the coronavirus, tanker tradeflows could change. In a world of significantly lower oil prices, transportation costs will become more important. Everything else being equal, it will tend to favor the short-haul suppliers over the long-haul producers; i.e. Middle East producers will gain an edge in Asia relative to Atlantic Basin producers. U.S. shale producers will target more customers in the Atlantic Basin (NW Europe, Mediterranean).
- **Longer term (>6 months):** Lower for longer, i.e. depressed oil prices for an extended period of time will lead to production cuts at higher cost producers (e.g. U.S. shale, Canadian oil sands). Production cutbacks by U.S. shale producers will almost immediately translate into a reduction in exports. This will have a negative impact on ton-mile demand, in particular for VLCCs. Even when the coronavirus threat starts to recede and oil demand and prices are recovering, it will take some time for U.S. producers to come back.

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