



EXPLORING THE IMPACT OF COVID-19 ON THE ENERGY MARKET

Wikistrat's COVID-19 Webinar Series
April 12, 2020





WIKISTRAT'S COVID-19 WEBINAR SERIES

EXPLORING THE IMPACT OF COVID-19 ON THE ENERGY MARKET

BACKGROUND

The outbreak of COVID-19 has led to a sharp drop in oil prices and demand, impacting many oil-producing countries in the MENA region and the global energy market. Adam Hoffman from Wikistrat interviewed Dr. Thomas W. O'Donnell, analyst and consultant on the global energy system, to discuss the impact of the epidemic on the energy market and its implications for Saudi Arabia's price war with Russia.



Dr. Thomas W. O'Donnell

is an academic, analyst, and consultant on the global energy system, especially oil and gas, and international affairs. His Ph.D. from the University of Michigan at Ann Arbor is in nuclear physics. For 15 years, he has taught primarily post-graduate seminars on energy and international affairs, and development (especially on OPEC states of the Mideast Latin America, the USA, EU, Russia and China) at the University of Michigan, Ohio State University, New School University's Studley Graduate Program in International Affairs (NYC), Freie Universität-Berlin's JFK Institute (Berlin), and currently at the Hertie School of Governance, Masters of International Affairs Program (2016, Berlin) and Freie Universität, European Studies Program (2016, Berlin). His popular blogsite is GlobalBarrel.com.

KEY TAKEAWAYS

COVID-19 caused a simultaneous demand and supply shock. The first time this has happened since the 1930s: As a result of the COVID-19 pandemic and the shrinking of global demand that it has caused combined with the oil price war that ensued, we can forecast that there is now about 5-10 mbd (million barrels per day, as of March 24) in excess of global demand. This is not only a demand shock but also, simultaneously, a supply shock. This will be increasingly difficult to manage. This is something that has not happened since the 1930s.

Russian pushback against American shale is counterproductive: Oil producers in Moscow see Western sanctions in the aftermath of the annexation of Crimea and the war in Ukraine, and more recently the American sanctions on Nord Stream 2, as significant constraints on the Russian oil industry. The refusal to cut production is based on the need to preserve the Russian market share vis-à-vis the American shale industry. Hurting the shale industry in the short term will not, however, mean that these firms will be driven out of the market, they will probably either be bailed out by the government or sold to others, which will better reorganize them. Such behavior is unlikely to push Congress to lift those sanctions.

A weak Chinese market is a problem for Putin: When the Chinese started declaring force majeure, they did not have to take delivery of contracted gas. This created a problem for Russia. The Chinese market has become a problem for Russia now, and this might have repercussions on Moscow's considerations.

Recovering from the impact of COVID-19 will take a year and a half to two years: The storm of COVID-19 is still to reach its peak in Europe and the United States, and there are several regions in the world, like Africa and Latin America, that are just starting to show the signs of the pandemic. That said, it is not just a matter of when the emergency will end, but how much time the industry will require to get back to the output levels of production it sustained before the virus hit. This will take as long as the global economic recovery, probably at least a year and a half to two years.

LIVE WEBINAR: FULL TRANSCRIPT

Wikistrat: Welcome to Wikistrat's Special Webinar on the coronavirus impact on the energy market. In this webinar, we have Dr. Thomas O'Donnell, an academic, specialist, and consultant on the global energy system. Tom, you want to start off with a story, so we'll start with that and then move on to some general questions.

O'Donnell: Like any big fight or squabble, you can start the story at many different places to make some people look better or worse. Let's try to do it this way, first little background: as everybody probably knows, shale production from around 2005 or 2007, in the United States, has ramped up so much that it caused a problem for OPEC, for the Saudis, and for the Russians, continually taking market share. In 2014, the Saudis wanted to do the classic thing, cutting output to staunch the declining price, a story which foreshadows what is happening now, from March 6 of this year.

In 2014, the Saudis went to OPEC, and they said, "Now, we, OPEC on our own, cannot cut enough oil to really have an impact on the market; US shale output is rising and will just take whatever market share we surrender if we cut output." So, they went to the Russians, they met with the Russians, the Mexicans, and others, and the Russians refused to join them in a cut. Nobody would cut with them. So, the Saudis said it was impossible to cut alone, we would do all the cutting, and

we would just surrender market share to US shale oil producers, the frackers.

So, they started a price war, which they really did not want, but they saw no alternative. They launched it; they took on shale and it did not go well. I think the Russians will come back to this end too in the oil price war of 2020; they too have now miscalculated in starting their price war against US shale producers.

In 2014, the Saudis had all these theories that US shale producers would be defeated by very low prices as they dumped oil on the market. But, in fact, those US shale producers who were able to persist, increased their productivity, for example in West Texas and Oklahoma especially; in many cases from 400% to 450% in a couple years.

The price war was a disaster for the Saudis and, instead, they were forced to, essentially, surrender. Finally they were able to make an historic agreement, in 2016, with the Russians, and actually, with a total of ten non-OPEC countries, but mainly Russia, that jointly, they would cut production. This group, together with OPEC, is called OPEC-plus. And little by little, they started over the next few years to gradually get some control of the market, even though shale was still increasing its production rate by about a million barrels per day during each year. By December 2019, OPEC-plus had collectively

cut about two million barrels per day of its members' production. At the same time, US sanctions on Venezuela and Iran, plus the war in Libya had removed about another two million barrels per day from the market. So, in January 2020, there was a feeling that OPEC-plus was perhaps learning to live with the shale producers. Oil prices were in an acceptable range for most OPEC-plus members.

Suddenly, what happens is that the COVID-19 crisis came along. It hits China at the beginning of the year. By about February, it seems, it is hard to say with certainty, but demand for something like four million barrels a day had exited the market. What is worse, nobody knows what this is going to lead to over the next year or so; five to ten million barrel reductions in demand, experts estimated, were gone by, for example the time OPEC-plus met in Vienna on March 6.

So, the Saudis took the coronavirus development very seriously; they went to OPEC, they went to OPEC-plus, and after a lot of lobbying by Riyadh, every member of OPEC-plus agreed that, besides the two million barrels per day they have already cut together as of the previous December, they needed to cut another 1.5 billion barrels, with the Russians expected to cut 500,000 million barrels of this total.

In Vienna, at the extraordinary March 6 conference, everybody agrees, all the non-OPEC and all the OPEC countries. But the Russians were late. The Russian energy minister, Alexander Novak, shows up after all the others had finally reached agreement on a joint cut and says, "No, we are not going to do this, we are not going to let the American shale producers, again, take the share that we cut". The meeting is stunned. The Saudis were livid at the Russians for blowing up the whole deal they had worked for. This is how the oil price war begins.

Now, the Russians at the meeting made sure that everybody knew what was on their minds. Delegates explained that Igor Sechin, CEO of Rosneft, which produces 40% of Russian oil, not only wants a war on US shale, he is also extremely angry at American sanctions. These sanctions include on Rosneft's involvement in Venezuela, and in response to the 2014 Russian invasion of Ukraine and its annexation of Crimea, and Sechin is angry at American sanctions that have halted construction of the Russian-German Nord Stream 2 pipeline. All these sanctions constitute substantial setbacks and constraints on Russian energy. And, this Russian energy oligarch has had it. Delegates were explaining this to everybody. And, in the next days, Sechin himself, in Russia, repeatedly spoke to the media, repeating these points and boasting that Russia can win an oil price war now against US shale. His rationale is the Russian state now has a huge war chest in the form of its reserves, well over \$550 billion, and could spend this money for several years during an ultra-low price environment, if needs be, to beat shale, and also outlast the Saudis. The money would be spent to make up the difference between the low price of oil and the price of oil needed, about \$42 per barrel, to support the Russian state budget.

Wikistrat: This is the broader, geopolitical context here between Russia and the Saudis, which sets the stage for the current crisis. But how exactly does the COVID-19 crisis play into this? How much of an effect will we see as a result of this global epidemic?

O'Donnell: If you are asking about energy, it is pretty dramatic. The amount of energy the world consumes, especially oil, but also natural gas to a great extent, pretty much tracks economic activity. When you get any downturn, not even a recession, immediately there is too much oil on the market and this has to be adjusted. In those instances, we

might be talking up to a million or perhaps two million barrels per day. But now, if you can imagine, at the time of the Vienna meeting, March 6, it looked like it could be five to ten million barrels exceeding market demand, and this is very dramatic. [After note: by early April, the IEA was projecting as much as 25 million barrels per day could be lost as the pandemic gripped Europe and the USA.]

Even in China, where they say it has mainly passed, we can debate how much the production has come back up; maybe half, maybe 60%. Different people have different numbers. But it is just rolling into Europe and it is rolling into the United States, and it is going to take quite some time. This is something that historically has not happened since the 1930s.

This is not only a demand shock, that is to say a lack of demand, it is also a supply shock so an under-demand and an oversupply simultaneously. That is not so easy to manage. And, in the course of this, the Russian side decided against cutting supply, preferring to dump oil on the market. The prospects are not exactly rosy.

Wikistrat: How is the energy market reacting to the pandemic so far? What were the initial reactions in the energy market to this trend?

O'Donnell: So, around January, the price of WTI crude was about \$63 a barrel, which is something OPEC can live with. But then, from January, it starts dropping already. There are stories about economic activities slowing down in a lot of places, not in the United States, but elsewhere in the world. Then, you get into February, and it is coming down again – \$52, \$53 a barrel, and then suddenly COVID-19 hits. Demand starts falling out in China. By March 6, the magic date when OPEC convenes, it has already dropped about \$18

to \$45 a barrel, \$46 a barrel. It was falling pretty rapidly.

However, from that day, when the Russians walked in and said “no” and blew up that meeting and declared the price war, the slope of the trend line is almost vertical. From that day, it had gone down from about \$45 a barrel, or \$46, to about \$23 today. That is a huge fall.. Actually, the loss of demand due to less consumption in China is worse than it appeared; a good part of the demand that we have been seeing in China during the COVID crisis has because they are buying cheap oil to fill their strategic reserves, their storage, at bargain rates.

Wikistrat: Going back to the Russian actions you just mentioned, what is now their energy response to the coronavirus crisis dramatically slashing oil demand?

O'Donnell: Russia has certain difficulties because of the sanctions the United States and Europe enacted in 2014 in response to their annexation of Crimea and the war in eastern Ukraine. Due to these sanctions, they cannot expand, domestically, oil and gas production into new areas very well, into the Arctic, into offshore, and they are unable to acquire the necessary technology also for fracking, that kind of thing; anything new. So, they were under a lot of constraints.

What Mr. Putin and Mr. Sechin saw is that it is impossible for OPEC to get control of this, or OPEC-plus to get control of this. No matter what we do, demand was already dropping drop five to ten million barrels and we cannot get control of it; we might as well dump oil on the market and try to grab market share and drive out the Americans. So, there is a certain logic, you can say, to this.

However, there is another aspect here. To the Russians, the reason they believe can win

this war and why according to the boasts of Mr Sechin and other officials it is logical for them, is that, over the next year, they say they can dump another 300,000 barrels on the market to hurt the Americans, American shale. Of course, prices will get really low; but, they boast that they have reserves of over \$500 billion. They say that these reserved can make up the difference in what the state's budget will lose from oil revenues. Even though the price might be floating at around \$20 or \$15 a barrel, and they would need prices ranging around \$40 a barrel for their state budget, they feel that is okay because they have \$500 billion in the bank, and, as Mr. Sechin has boasted, this will allow them to supposedly keep up the price war for several years, and bury US shale.

Now, the thing about their big reserves is that they were supposed to be spent to improve the conditions of the Russian people so that they will not continue, increasingly, to see the regime as being so problematic, which is what has been developing. However, if they spend that money to, let's put it as it really like it is: to de facto subsidize cheap oil for China for those years, and they give up developing their internal social programs, that is not actually the end of it. Sechin boasts that they can do this; however they are not factoring in the COVID crisis. Russia is just beginning to be hit and knocked out like everybody else, who knows how much. Look at the relief legislation being passed in EU states and in the United States today. I think this brings up the logic that they are puffing up their chest as though they were saying, "We have all this money in the bank this time, it is not like 2014, when we suffered during the price war the Saudis launched then. This time we can stand the low prices and other societies cannot" and they boast they can bury the Saudis too. But per capita, the Saudis have five times as much money in the bank, so we shall see.

Wikistrat: Moving on to the Saudis and the Gulf states here, what do you see is the likely impact of the COVID-19 drop in all demand on the Gulf states, on their economies, and also geopolitically?

O'Donnell: It will be disastrous. The Saudis' reserves have not recovered, but continued decreasing, after dropping in the oil price war back in 2014; In fact, that was a lot of the impetus, obviously, for Crown Prince Mohammed bin Salman to decide that the country had to change structurally. It could not afford to be so dependent on oil in the future, and that is his Vision 2030. Now, however, as we know, it was difficult to keep the price of oil up using OPEC-plus in the past year, in 2019, by making cuts together with the Russians. So, it was difficult to keep the evaluation of Aramco as high as they wanted when they privatized a portion of Aramco, and they are struggling with these issues. This is why MbS puts princes in detention, to shake them down for money.

They are in a difficult economic situation. They want to maintain the price as best as they can to get on with the reform program. However, now the Russians have blown a hole in that, and there is an oil price war and they are really hurting. However, they can go through this; tactically, they are better positioned to cause pain to the Russians than the Russians the other way around.

So, this is how the Saudis decided to fight the present oil price war, de facto taking US shale, which is something they absolutely did not want to do: The Russians can dump up to 300,000 barrels on the market this year. The Saudis, on the other hand, can dump two and a half million barrels; but they are going to do so in a very particular way. They're going to dump it at several dollars a barrel less than the Russians are selling their oil for, in Western Europe and in Asia, where the Russians mainly have their market. They will

do it in a way to cause maximum damage to Russian oil business. They intend to make the Russians pay for starting this.

Wikistrat: Are these steps going to be enough to mitigate the shock effect of the COVID-19 drop in oil demand across economies?

O'Donnell: It will not be, and it is going to be very painful for everybody. The Saudis are livid with the Russians for this. Who is it really going to be bad for, in the Gulf area, but especially the immediate region in general? Any country that cannot increase their production right now and, as the price falls, produce more oil like the Saudis can, like to some extent the UAE, and make up for it in some way, and that doesn't have a lot of money in the bank to get through it. All the other OPEC countries, they can not expand their production. They can lose 85%, over the next year, of their revenue stream from oil, and that is a huge crisis in the region; and that too will turn out to be a big problem for the Saudis.

Wikistrat: Looking more geopolitically, could that maybe exacerbate the existing competition between the Saudis and everyone else in the region looking in terms of oil production?

O'Donnell: I would say the Saudis were not pleased with what the Russians were doing in Syria, Lebanon, and, with the Iranians and Saudis, trying to play both sides of the game. Now that Putin has behaved in such a way, I would say relations are going to be pretty bad in the region, as far as that goes. We have not talked about the United States yet – that is a whole other aspect.

Wikistrat: So let's move on to the US position on this production competition and the impact of the COVID-19 on the global energy market.

O'Donnell: As we know, the virus is now spreading in the United States and the situation is going

to obviously get quite bad. It might be the center of the pandemic for a while now. US demand is going to drop, it is going to be very painful, like every other country getting hit, but 5% of American economic output, or maybe slightly more, is linked to oil, and now the United States oil sector is going to get hit pretty hard by all this oil being dumped on the market. The difference here for the United States and for the EU, as compared to what is normally the silver lining of any kind of oil price war, is that normally lower energy prices tends to boost energy consumption and stimulate economic activity. This, however, is an anomalous situation, because of COVID, such a scenario will not happen, so the oil sector and gas sector in the United States will just have to face a painful period.

It will be interesting to see what the response of the Trump administration and Congress is going to be to what will be seen as a joint Russian, Saudi price war against US shale; and the Saudis traditionally get the brunt of the blame in the USA. . What I see now, in looking at it, is every possible response that might favor different sectors, the two main parts of the oil sectors [Note: the relatively smaller, independent oil producers in West Texas and other regions have for generations had different interests than the major, US-based international oil companies. The latter are represented by the American Petroleum Institute (API) and oppose any government-mandated control of oil production or imposition of protective tariffs in an oil price war, while the later, well-represented by journals such as "World Oil," favor re-activation of institutions such as the Texas Railway Commission, which up until 1973 did control production levels in Texas, still have legal authority to do so, and whose present-day chair is favorable to the idea. Also, this later group of "independents" has always been deeply antagonistic to the Saudis, as are most of their congressional

representatives; and this group tended to instantly placed blame for the present price war on the Saudis, not the Russians. Meanwhile, the “majors” have historically had more political clout among senators and the State Department, etc. So, Trump, who thus far is seen in a positive light by both camps, might want to procrastinate, not doing anything decisive for either side to avoid the other turning on him.], the financial sectors, politicians more concerned with either producers or consumers - each is proposing their own sort of classic solutions that address their group’s interests. It is definitely going to be a while to figure out which one wins.

Donald Trump does not like to see oil over \$70 or \$75 a barrel, so every time prices rise up in even the high \$60 or into the \$70, he turns to his buddies, the Saudis. He starts tweeting: “Open the taps, open the taps!”, railing against OPEC in an attempt to bring economic activity up.. Well, now OPEC has really “opened the taps,” along with the Russians! And now what happens? There is economic ruin in sight and there could not be a worse time for it to happen – during a pandemic. So, what is he going to do? He has to explain to his followers that this is not what he meant by “opening the taps.”

Now, there are a couple of things that could happen. On the one hand, it seems like the administration is pursuing more intensified diplomacy. Normally, I would think that the United States, whoever is in the White House, would see how the Saudis were forced into this and are mainly directing it against the Russians, so they would engage in diplomatic efforts to resolve this issue, to somehow bring the Saudis and Russians together to make a deal and calm down. Of course, what both the Saudis and Russians would ask is: if we agree to cut output and end the war, what contribution will the USA commit to to low the oversupply of oil on

the market? They would insist that US shale producers accept some of the burden.

In fact, there are ways the USA could do this. People from the Texas Railway Commission actually have a legal right to control the production in Texas, as do analogous institutions in at least Colorado, Oklahoma, North Dakota and New Mexico. They have not done so [controlled the production] since 1973. There are discussions that maybe they should meet with the OPEC and engage in this. With the crisis this deep, this would be a historic event that has not happened in the United States for decades; but, of course, was common in the depression era and for years after; there were all sorts of production controls managed by the federal government in agriculture, oil and elsewhere. To avoid anti-trust complications, Trump would have to make a political decision to invoke national security. Also, Eisenhower put protectionist taxes on the imported oil.

So, there are possibilities for the USA to also overtly or de facto cooperate in some OPEC-plus global production regulation. Other possibilities reside in the hands of Congress. There is widespread support for this NOPEC bill – a move to declare OPEC to be restraining of trade, to be an organization that illegally manipulates markets - but this path is a little strange. It was when the prices were going higher when, especially Democrats but Republicans also, would say, “Ah, OPEC is a cartel. It is unfairly fighting against American oil and propping up prices artificially; we have to knock it out”. That kind of thing. But now, it is the other way; OPEC is not trying to limit production and drive the price up, constraining economic difficulty, they are actually dumping. So, it is a little illogical to pursue this bill in the context of an oil price war, And the Trump administration has shown interested in it. Something else that could very likely happen is a bailout. The shale companies, maybe a fifth of them could go

bankrupt, according to early estimates, and the Treasury Department might start buying up the bad debt like they did with the banks and with the auto manufacturers in 2008. There is a good chance for that to happen. But, in any case, I can hardly imagine the Russians actually succeeding in killing shale. It is all there; the technology and the resource is there. The human know-how, human capital, is there. The ones who go bankrupt will in time be bought by people with deep pockets, and it will be difficult, but in the end, when the prices come up again, they will come back.

This seems to me like a case where the Russians punched the big guy in the nose; but like my karate teacher always warned me: you cannot win by punching a big guy in the nose, you just get them very angry. And if Putin and Sechin were trying to get rid of US sanctions on Russian energy, finance and other sectors, imposed for well-known aggressive and predatory behavior by the Russian state, now, with Moscow initiating a price war that will only exacerbate the effects of the pandemic's energy and economic crisis, Congress is only going to get more angry and might very well impose more sanctions. It is important to remember that these tranches of sanctions of Russia are a deeply bipartisan issue. It is a little hard to see the logic of the Russian approach when they say a goal of going after US shale is to get sanctions relief, or undermine the ability of the US to impose sanctions.

Wikistrat: Looking at COVID-19 from an investment perspective, who might benefit from this situation and who is likely to lose from the virus's impact on the energy market?

O'Donnell: I guess there are people that, in the future market, might have bet the right way and they will make some money. Other than that, it is kind of hard to see who is going to profit. As in any crisis, people with money to invest

can buy up firms in trouble for bargain prices. Oil is not going away. 95% of all transport in the United States and 94% of all transport in Germany is based on oil; that is universal. People will buy up shale companies, sooner or later, and it will probably be, in the long run, a good investment. \

But then, who benefited from the Great Depression? It is kind of like asking that question, if you understand what I am saying.

Wikistrat: What do you think are the new opportunities represented by this current crisis in the energy market?

O'Donnell: Opportunity? Well, I would say at some point it is from consolidation. Individuals with deep pockets come in and buy up companies that have great tech, great land, and resources, but are presently over leveraged. In the course of the last several years, shale companies scrambled to constantly increase production and acquire market share, and borrowed considerable amounts of money in the process, so the ratio of their debt to income is pretty concerning right now. But, as a number of analysts have said, it seems the Russians do not understand American bankruptcy law. The company, or at least the oil fields and equipment do not disappear; somebody else acquires it, or they reorganize. There are people who will partake in that sort of thing, in M&A. The only question is how soon and which oil fields become once again profitable, at what market price.

Wikistrat: First question from the audience: What would be a sensible timeframe for global energy consumption to return to the pre-crisis levels?

O'Donnell: If we take the President of the United States as an authoritative source, next month! He wanted the country "opened up" by Easter. Yet, should we follow other people's estimates, it is going to take a couple of

years. Firstly, it will take some months for the pandemic's peak to pass through Europe and the United States. Maybe we can forecast this to happen by the end of summer: there will be a long tail on this, on the infection time series distribution. Secondly, you have to realize there are parts of the world that are really not yet fully involved in it right now – Latin America, Africa, some other parts of Asia – where it is certainly going to spread. I would also say, I was listening to the head of the Doctor's Trade Union in Russia today in an interview, that, because of Russia's poor transport system, with vast, very isolated areas, leaving aside big cities and busy borders areas, it might be a miserable, slow burn there, for a long period of time.

Therefore, I would estimate a couple of years, or a year and a half at least. When the emergency will have passed, it will still take some time to re-establish production, to re-establish those levels. I am confident that there will be a certain bounce because we will experience bent-up demand. But, particularly because of the disruption of global production networks, and because different portions, different countries, will be affected at later stages, we will see how long it takes to come back. Six months? A year and a half? I would not be surprised. This is putting aside some sort of systemic damage to the economic and financial system that persists, that fiscal and monetary policy does not easily recover.

Wikistrat: So far, we discussed oil, but what about the impact of this crisis on other forms of energy? Has the spread of COVID-19 affected other energy markets such as nuclear, solar, wind? Is this crisis going to shift demand from oil and gas to renewable energies?

O'Donnell: There are two aspects to consider. The situation regarding gas is a little complicated. Gas producers in the United States were producing too much gas and the prices were

so low that they did not know what to do with it. That happened due to the fact that, as oil producers frack for oil, it simultaneously produces gas with it as well; this is called "associated gas." Thus, they kept producing gas that they did not have a market for, hence we've had long-term low prices in the USA. This is what drove the fact that economics were good to go for developing what has been expected to amount to 200 billion cubic meters a year of new LNG export capacity. This was supposed to come online over the next few more years, from Louisiana and the Gulf region. The advent of the COVID downturn in demand, not to mention an oil price war, that causes abundant oil fracking operations to go offline should decrease the oversupply associated natural gas, and somewhat strengthen the price in the North American market.

However, in Europe, almost 40% of all natural gas comes from Russia. Russians like to index it as much as possible to oil, therefore this is going to kill the price of gas a certain portion of Russian gas there. For several years, Moscow has been afraid of a gas war with the United States, with liquified natural gas (LNG) coming in and competing with Russian pipeline-delivered gas – whether oil indexed or not. Actually the trend is that less and less is oil indexed. How this competition plays out is going to be a little bit complicated, but this might advantage Russian gas to a certain extent, I think, in Europe. It might be a certain respite. But, longterm, no; LNG will still come ramp up to become the majority of gas supply in long distance trade, and pipeline delivered gas will be in second place.

Renewables are also a very big deal. My view is this: the EU, for example, first started having projects from 1999 and 2000, setting goals for renewables again and again, which in the end were almost always not met. Almost every time, when you look at it, this was caused by the oil and gas price cycle. Oil

is what competes with electric vehicles and natural gas competes with wind and solar generated electricity and is needed for quick generation ramp up when wind and sunshine suddenly diminish. Everybody (aside from veteran oil experts) thinks that, when the price of oil gets high [it] is going to stay so forever, in a doomsday-like scenario. The same with natural gas. However, there is a huge resource supply of both oil and gas, and more and more oil and gas comes online. As such, overly optimistic plans for renewables are often made in these periods of relatively high oil prices. Then, when the price of oil and gas crashes, it becomes very difficult for renewables. Well, here we are again. This will happen once again.

Of course, nowadays, renewables are more competitive than before. Some people might say let's do this because oil and gas have once again proven to be volatile. But, whilst being volatile, they are also often very cheap. As such, this has always been historically really bad for renewable goals.

Wikistrat: In other words, dropping oil prices as a result of COVID-19, will basically impact our assessment of all the different types of energies, not just oil.

O'Donnell: Yeah, economically. Yes, there might very likely be also political programs to try and preferentially boost renewables, as part of a recovery strategy; but we will see. In the end, they have to be paid for and they will once again be less competitive while oil and gas are in oversupply and very cheap.

Wikistrat: What is the more prominent factor in your assessment behind falling prices of oil in the present? Is it falling due to demand or due to COVID-19?

O'Donnell: Demand. Not in the United States so much, but in the world as a whole, the economy was already not vigorous into this year. Demand

had already been falling at the beginning of the year, before COVID. In a situation where we expected a recession in Germany, and with similar of borderline situations in many other countries, then COVID hits. And that simply takes demand offline. So, you already had a lot of places where demand was fairly weak, and then this is like a bomb as far as the productive capacity that's being destroyed. I think they're working together, the previous economic weakness and the COVID impact, but COVID blows away the other one, yeah.

Question: What does this all mean for Nord Stream 2?

O'Donnell: Ah, yes. Nord Stream 2 is the big pipeline that runs from up near St. Petersburg to near Greifswald in Germany via the Baltic Sea. The United States put sanctions on it at the end of December, stopping construction, and the only ships with capacity to lay that pipe will no longer risk working on the project. So, I think it is the ugly way around. If you take the Russians at their word, and they have repeated this a number of times, it is because the United States put sanctions. While they say, "Don't worry, we can finish building the pipeline ourselves", they seem to be pretty upset about it. And they list this as one of the main reasons for why they want to launch this war, and sort of get vengeance on Washington.

I would say, from listening recently to people in Washington who have worked on this for a long time, retired ambassadors, people at the State Department talking about it, and the word in Congress is that these sanctions will never come off. If the Russians build the pipeline anyway, Washington will very likely find another way to hit it, to sanction that pipeline in some other manner, but they are going to try and find some way to really prevent this project. From the US point of view, and the point of view of many EU member states in Central and Eastern Europe, the

Baltics, and Scandinavia, this is a project that enables Russia to find a way around having its gas having to transit, Ukraine, a country it is at war with and wants to continue that war, and continue doing its business in Europe. So, this new pipeline that was stopped in a late stage of its construction, Nord Stream 2, is a joint German-Russian project to accomplish that,

So, these sanctions are not a very positive situation if you are one of the European energy companies partnering with Gazprom that invested in it, I would say. It is a bit unprecedented for the United States to do something like this that impacts so strongly, for example, partners like Germany or Austria. But that is the reality. There is deep bipartisan anger in Washington for Ukraine, for this pipeline, for propping up Maduro and for interfering in US elections. Launching an oil price war against US shale is, well, an rather curious way for Russia to hope to force the USA to remove all these sanctions.

Question: I just wondered whether, when the demand is going to fall for a longer time, it is going to take a while to finish it, if it can be done, technically, but the return may not be worth it.

O'Donnell: Absolutely, yes, the projected profitability for Gazprom is constantly declining. The project probably had a lot of difficulties. Western partners were unable to invest directly in it because it had been declared uncompetitive by legal processes in the European Union, by the Polish competition authority and so forth. So the Russians could not go to the banks as they had planned to, saying that half of this pipeline is owned by four big Western international oil and gas companies, and so get a good interest rate.. Putin had to find another way to finance it, more indirectly. And that is difficult to begin with. Now that sanctions have stopped the construction, after spending likely almost the full 10 billion

Euro initial cost estimate for the pipeline, and it does not come online, and at the same time there is so much American gas, but not just American, Australian, other gas coming into the European market, also potentially from North Africa, we shall see. . The longer the Russians are delayed in completion of this new huge pipeline to allow them to bypass Ukraine, the more the European system develops and gets restructured in a way independent of this new Russian gas. It will be problematic. The commercial viability of it starts to go down.

Wikistrat: How do you see the effect of COVID-19 on the Russian-Chinese relationship, in terms of both energy and geopolitics?

O'Donnell: There are two aspects to consider. On the one hand, when COVID hit, the Chinese started declaring force majeure to avoid having to accept and pay for previously contracted oil and liquid natural gas (LNG) deliveries for which they now had no use. They did not want to take delivery, for example, of contracted LNG, not only from the United States as LNG but also from everybody else, from the Russians, Qatar and others.

So, what happened is that this created a problem for Putin. He had already not gotten the best price for gas that has just recently begun to flow through his new big, expensive pipeline to China. He made that deal under a situation where he wanted to prove he was not completely dependent on Europe as Russia's gas-export market after 2014, after his invasion of Ukraine when sanctions were put on parts of the domestic Russian oil and gas sectors by the West in retaliation. He wanted to show that he had an alternative. But, now the Chinese market has become problematic now. So that is difficult. And, also, with oil, Russian sales to China and Asia are being undermined by the coronavirus economic downturn.

Now, perhaps I could just say the particular strategy of the Saudis in this oil price war that has been forced upon them, is to dump oil on the market in a way that seriously undermines Russia. Russia always has competed, especially in recent years, with the Saudis and the Gulf region for the Asian oil market. And, China would swing back and forth, more or less playing a game between the two suppliers, Russia and Saudi Arabia, so that China would always get the best price. But now, the Saudis are offering \$5, \$6, \$7, maybe \$8-barrel reductions in the cost, just to kill the Russian market for Russian oil in Asia. This is going to be difficult for Russia.

I should add that the other place the Saudis have said they will especially dump oil is in Western Europe, at several dollars per barrel below whatever the Russian charge there. The problem Russia has is that most of its oil exports go abroad via pipelines, such as the huge Druzhba pipeline from western Siberia, with many feeder lines, to the west across Belarus, Poland and into the Baltic states, Germany and elsewhere. So, being a single big pipe, the Russians mix all sorts of grades of oil from disparate fields and the refineries get what they get. However, the Saudis will sell by the shipload and offer whatever grades are optimal for local refineries in Europe. Clearly, the Saudis are out to teach Messers. Putin and Sechin a lesson. This, I expect, will seriously unnerve the Russians in the coming weeks.

Question: China has imported quite a bit of oil from Iran. How does Iran fit in the picture?

O'Donnell: The reimposition of sanctions by the Trump administration has been really effective as far as killing the exports of oil from Iran. It is probably under a million barrels a day or so now. They fill up on as many ships as they can get their hands on with oil they cannot sell. And what they can sell has really, really

come down. They find themselves in a very difficult situation. They are selling a minimal amount of oil and I believe that the Chinese are not extremely anxious to buck the US sanctions. They will not go out of their way too much to take Iranian oil. But now, with the price fall, Teheran could easily lose 70% or more of the value of whatever oil they are still selling. This is going to be really devastating for Iran. On top of this, there is the internal COVID crisis, which the regime is handling very badly.

Question: I thought China and India were important customers of the Iranians.

O'Donnell: But there has been such an oversupply on the market. So, geopolitically, the United States has had great leeway to impose sanctions and take all sorts of oil off the global market without having any real detrimental effects as far as price rising. A good deal of oil has been taken offline, and there was still an oversupply issue before the COVID crisis hit China. Libya is not sanctioned, and the civil war there had essentially taken the country completely offline. The USA has largely taken Iran offline, and this had had very little effect because there was so much other oil out there and, now with the demand problem, there is no market reason that problematic, sanctioned Iranian oil is needed by the Chinese or, in fact, for the sanctioned oil from Venezuela that Rosneft wants to sell India and China. In this oversupplied market, the Chinese and Indians are happy to go along with the sanctions. The Chinese are also ticked off at Maduro, for messing up their investments in Venezuelan oil; they have had it with him. And the Indian companies too. They have also gone along, pretty much, with the American demand not to buy oil from Venezuela. It is a situation where nobody is going to make a big fight over these things when the market is flooded with other cheap, unproblematic oil.

Wikistrat: Tom, how do you think that this COVID-19 crisis will impact China's energy market? How will China's energy partners and clients, both in the immediate region and globally, look at Beijing? Will there be some changes in the motivations to do business with the country, given that the COVID-19 started in China and is also being labeled by some politicians as "the Chinese virus", not only the coronavirus? How do you think this will impact China's standing in the global energy market?

O'Donnell: The demand in China has no longer been growing the way it was after about 2004 or so, for a decade; although, it is still going to significantly increase. China is the main importer of oil in the world now, and that is going to go on for a long time. People who sell oil and gas are not so concerned with what the regime might be, they are going to do business. China is not exporting this stuff; it is almost entirely importing. What China does have is this whole Belt and Road Initiative, and a very small percentage, a couple of percent sometimes, of what they're actually doing across the whole Eurasian land space, through the Caspian Sea and onwards, is actually what we would refer to as renewable energy. Wind or solar though some big projects, but mainly, it is coal-based projects, creating infrastructure and so forth, and continuing in earnest their acquisition of oil and especially natural gas from states such as Turkmenistan.

What it might cause to the relationship between China and those countries is a mixed bag. Some elites benefit from the relationship, but in general, many of the elites and people are also at the same time very weary of what the Chinese project is. The Chinese soft power does not go so far. Everybody knows how they operate at home, inside China. If your choice is between the soft power from the Russians and soft power from the Chinese, well, you play it back

and forth. There is a lot of that happening currently.

I have to say, in the region [i.e., Central Asia and the Caspian, where the Belt and Road is very active], I think the European Union is kind of out of the game. The German government, right now, is trying to have a big project again, getting involved in renewables in the region. Not to try to out compete China, but just so they do not lose too much of their influence and business relative to China too rapidly.. I noticed the United States has changed its attitude, talking about how the Chinese can come in and launch all these projects, and we cannot do that so easily without the appropriate types of finances, of loans and aid. So, they have made some changes; the US had an idea and founded another organization (the Blue Dot Network), starting out with a sum of about a billion dollars. Pompeo keeps talking about how we can invest this money now without so many strings attached for projects that countries need and begin providing an alternative to China. Given the potential capacity of the USA, if it really pursues this, this is something to watch.

It might be the beginning of the United States going through the region and getting involved. We shall see what happens. They had a 25 or almost 30 years-long now, project in the Caspian Sea region, which has been an energy strategy that has gone toe-to-toe with the Russians in the region. And they are starting to do the same thing in Eastern Europe, increasingly, where it is targeting Russian influences. So, this is a program of pushback to the Chinese in these regions as there is too against the Russians in Eastern and Central Europe. This initiative predates Trump, back to the Obama Administration. It is all subsumed under the latest National Defense Strategy of "Great Power Competition."

Question: What effect does the recent development in China have on the traditional Chinese policy of establishing new coal-fired power plants? For a while, it was a new coal power plant every two weeks.

O'Donnell: I have not looked into this lately. In about 2015, a lot of promises were made by the Chinese with regard to how much they were going to reduce the building of coal plants and the use of coal. Obama's head of the Energy Information Agency, who went to China, had a meeting, and said, "Well, tell us about it", and they said, "Well, it is not really what you think it is." They came back with the data, and indeed it was not what you think it is. The Chinese were actually not doing nearly as well as they were saying in diminishing the use of coal. On the other hand, they do have a major security problem for the government, for the party, which is the pollution in the country. And it kills people. It is the equivalent of smoking several packs of cigarettes a day in many cities. That is a significant problem. So, to abandon coal and go into natural gas for electrical generation is

an important turn for them. They can resort to nuclear, they can resort to renewables, but they cannot transition that rapidly to either one of those. And so, natural gas is very important to them, and this will increasingly translate into consistent, largescale imports from the United States, and this will hardly change. That is going to be a complicated story. I would not consider the gradual, but earnest, Chinese move away from coal t so much as the fact that it lowers CO2 emissions; which is a real security problem with respect to popular outrage against air pollution. It will really improve air quality if they go this way. This also means they will continue to hook up with the Russians for more natural gas. .

Wikistrat: Thank you so much, again, Tom, for these insightful comments and this behind-the-scenes perspective on the energy market and how it is really reacting to the COVID-19 crisis.



WIKISTRAT'S COVID-19 WEBINAR SERIES

EXPLORING THE IMPACT OF COVID-19 ON THE ENERGY MARKET

For more information on Wikistrat's crowdsourced solutions and systems, contact: info@wikistrat.com

www.wikistrat.com