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RUSSIAN GEOPOLITICAL OBJECTIVES IN THE CURRENT OIL PRICE CRISIS AND THE IMPLICATIONS FOR CANADA

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SUMMARY

The Russia-Saudi oil price war that devastated energy markets in March also illuminated the Kremlin's thinking. It revealed Russia's fears and just how far it's prepared to go to prevent them from becoming reality, even at the cost of wrecking promising alliances. In 2016, Russia and Saudi Arabia agreed to co-operate in managing oil prices through the OPEC+ agreement. Their partnership deepened to the extent that the Kremlin excused some of Saudi Arabia's recent dirty deeds, while the Saudis began making overtures to draw the Russians away from Iran in the Middle East.

That came to an end after Russia rejected OPEC's proposal to cut production by 1.5 million barrels per day. The Saudi response was to offer customers discounts of $6-$8 per barrel, sending oil prices into free fall. The dispute showed not only Russia's motives and logic, but what can be expected from Russia in future energy disputes.

Revenge on the United States is at the top of the list. The U.S. has punished the Russian energy giant Rosneft for helping Venezuela evade American sanctions. Russia is also angry at U.S. efforts to block the Nord Stream 2 pipeline to European markets. In March, Igor Sechin, president of Rosneft, convinced President Vladimir Putin that if Russia could keep oil prices below $40 a barrel for an extended period, U.S. shale oil would no longer be economically attractive and the Americans would lose market share.

Further, Russia knew that the coronavirus pandemic would suppress demand for oil, and prices would fall. An agreement with OPEC would have been an unwarranted favour to that organization.

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Russia also viewed Saudi Arabia as the underdog and assumed it could outlast the Saudis in this confrontation. As OPEC's informal leader, Riyadh has responsibilities to the organization's other members while Russia has more room to maneuver.

Thus, Russia believes the oil price collapse is cyclical and temporary, that the country's Stabilization Fund will allow it to weather the storm and that it has the stronger negotiating position.

Whether all this is true remains to be seen. Russia has proven itself a ruthless geopolitical player and its citizens are more accustomed to economic deprivation than the Saudis are. Russia also has the advantage of a floating exchange rate.

However, Russian political stability depends on Putin's popularity, which is not robust, especially as the pandemic hits harder. Russia also lacks the ability to substantially increase oil production and its actions have generated substantial ill will among other producers, including some with deep pockets and more energy reserves.

Russia did agree to production cuts in April and tried to frame the deal as a win. But with no end in sight to the pandemic and oil-price stabilization still a distant prospect, more disagreements between producers are likely.

This paper examines Russia's mindset and its strength and weaknesses, offering insights to help Canada prepare for the opportunities and pitfalls in energy markets that lie ahead.

INTRODUCTION: HISTORY

When former U.S. president Franklin D. Roosevelt met with Abdulaziz ibn Saud, the king of Saudi Arabia, on Feb. 14, 1945, they laid out the principles on which the contemporary global oil market would function. The arrangements agreed to at this meeting made the Kingdom the main supplier of oil to the U.S. in exchange for Washington guaranteeing its security. For decades, this alliance proved crucial, especially during the Cold War when Saudi influence on oil prices in the late 1980s led to the Soviet Union losing a large share of its revenue. Combined with other problems, this revenue loss set the stage for the Soviet Union's collapse in 1991 (Gustafson 2012).

Yet, starting in the early 2000s, this alliance weakened. To some extent, one could argue that the game changer arrived with the U.S.'s bet on the development of domestically produced shale oil in 2013. Production eventually surpassed seven million barrels per day and turned the partnership between Saudi Arabia and the U.S. into an intense competition. The outbreak of the Arab Spring in late 2010, and especially the Syrian civil war, resulted in increasing tensions between Washington and Riyadh (Mikhin 2014). Meanwhile, relations between Saudi Arabia and Russia deteriorated in the 1990s due to Russia's handling of Chechnya.

In September 2016, Saudi Arabia and Russia agreed to co-operate in managing the price of oil. This agreement ushered in a new form of partnership between OPEC – dominated by Riyadh – and Russia; the agreement was often referred to as OPEC+ (Tass 2016). The zenith of co-operation between the two countries was reached in 2018, when Russia supported Riyadh in its conflict with Canada over human rights (Balmforth 2018), and turned a blind eye to the assassination of Jamal Khashoggi, even tacitly blaming his death on the U.S. (Times of India 2018). The Saudis in turn hinted that "Riyadh is a better bet [for Russia] than Tehran" (Ignatius 2017) – a move that could have resulted in unprecedented geopolitical changes in the region. Despite this upward trend in relations between the two energy superpowers, early March 2020 brought an oil price war and the near-collapse of OPEC+, which stemmed from a conflict brewing between the two oil producers.

This paper discusses the oil price conflict between Russia and Saudi Arabia, which, despite having been supposedly extinguished after OPEC+ was signed, has left a number of uncertainties and blank spots. The research also examines the deal's potential implications for Canada.

WHAT HAPPENED IN VIENNA?

The first signs of a looming crisis appeared on March 1, 2020, when, during a meeting between Russia's main oil producers, Igor Sechin, president and board chair of the Rosneft oil company, reiterated his opposition to OPEC-promoted policies that maintained a necessity for cuts in oil production. According to informed Russian sources, Sechin wanted to retaliate against the U.S. for imposing sanctions on Rosneft Trading SA – the Geneva-based trading unit of Rosneft – because of its actions in Venezuela (Reuters 2020), and Nord Stream 2 (a system of offshore natural gas pipelines from Russia to Germany) (RIA Novosti 2019). Sechin convinced President Vladimir Putin that if Russia managed to keep oil prices below $40 per barrel for a certain period of time, production of shale oil would no longer be economically attractive, and the U.S. would suffer (Malkova, Stogney and Mironenko 2020).

As a result, during negotiations in Vienna, where OPEC is headquartered, Russia balked at OPEC's proposed production cuts of 1.5 million barrels per day. Rosneft spokesman Mikhail Leontiev said: "This deal does not answer Russia's interests", because previous oil cuts carried out by Russia gave American exporters the opportunity to replace Russia's share with U.S. shale oil (Latynina 2020). Consequently, on March 8, 2020, Saudi Arabia announced major oil price discounts of $6 to $8 per barrel for customers in Europe, Asia and the United States. The move caused "a free fall in oil prices ... with Brent crude falling by 30%" (Perper and Bostock 2020), and prices hit a new record low not seen since March 2001. Following the market crash, both sides claimed that the current situation – painful as it is for their economies – will have no detrimental effect. This means that the price of crude oil could go even lower, if circumstances warrant.

Russia's national currency was hard hit and Rosneft experienced a nearly $15 billion drop in value (Moscow Times 2020). However, Russian officials remained upbeat. Finance Minister Anton Siluanov, referring to the breakdown in negotiations and immediate economic difficulties, stated that Russia is ready for a period of low oil prices "even better than some other countries" – apparently referring to Saudi Arabia. He made it crystal clear that Russia is not planning to cut any of the spending included in the country's budget this year. At the same time, Alexander Dyukov, board chair of Gazprom Neft, dismissed the breakdown in the deal with OPEC+ as a key factor behind worsening economic conditions in Russia, since "the oil prices would have gone below $35 per barrel anyway." On the other hand, Russia's largest oil producers are determined to keep extracting oil at any cost, according to Nail Maganov, board chair, CEO and director at Tatneft PJSC, who stated that his company was planning "to continue oil extraction even if its price hits the $8 per barrel bottom" (Tass 2020a). Lukoil CEO Leonid Fedun was critical of this excessive optimism. Despite expressing his confidence in Russia's ability to eventually overcome this crisis, Fedun described current oil prices as "catastrophic", and suggested that "had the participants [of OPEC+] agreed on the new cuts, the [oil] price would have been $50 per barrel" (Gazeta.ru 2020).

EXPLAINING RUSSIA'S MOTIVES AND LOGIC

By taking this tough approach in negotiations with OPEC+, Russia has partly revealed the logic behind its behaviour (this could recur if oil-related disputes arise in the future), which I break down into three motives:

1. *Getting even with the U.S*. Russia's chief motivation is its strong and barely concealed desire to punish the U.S. by diminishing its role in the global oil market. Russia wants to achieve this by bankrupting or severely hurting the U.S.'s shale oil industry as punishment for its recent use of energy as a weapon against Russia's energy-dependent economy. Primarily, Russia is dissatisfied with U.S. sanctions against Rosneft – for helping Venezuelan authorities evade American sanctions – and the Nord Stream 2 pipeline, which is considered to be strategically important for Russia

economically and geopolitically. Russia believes that if oil prices are kept low for a considerable period of time, the U.S. will lose a large share of the global market due to the obsolescence of its shale oil, whose production costs are significantly higher than those of Russian oil, which might replace it. Later, the market will stabilize on its own and oil prices will rebound, once again reaching $35 (initially), then $50 (in the longer run) per barrel. Given that Russia's state budget breaks even at an oil price of $42 per barrel, Russia could weather the current painful economic challenges thanks to the safety cushion it accreted in the previous era of high oil prices and macroeconomic discipline. The Russian National Wealth Fund's total assets were estimated to exceed $120 billion as of December 2019 (Ministry of Finance 2020). This means that Russia could use these funds – at least for one year with virtually no repercussions for the country's economy – to mitigate the consequences of the worsening macroeconomic milieu. Furthermore, based on the World Oil Outlook (WOO), Russia believes that U.S.-produced shale oil will inevitably enter an era of stagnation (Chizhevskiy 2019).

2. *Awareness of the temporarily changing global demand* for oil caused by the outbreak and rapid spreading of the COVID-19 virus, which significantly decreased Chinese demand for crude oil (Raval and Sheppard 2020). With Chinese oil demand dropping by approximately three million barrels a day (20 per cent of total consumption) due to the coronavirus pandemic (Cang, Blas and Cho 2020), Russian negotiators in Vienna knew that oil prices would plummet, which would have made signing an agreement nothing but a favour to OPEC (a.k.a. Saudi Arabia), which Russia did not want to do. This foreknowledge clearly stemmed from a series of pre-Vienna negotiations between Saudi and Russian representatives that brought no practical result (Arkhipov, Kennedy, Tanas and Smith 2020), meaning that Russia had been preparing for this outcome. Importantly, leading Russian analysts attribute the current oil crisis to "emotional reaction of the markets" (RBK 2020a) – a situation they believe is bound to stabilize in the coming weeks and months.

3. *Hubristic perception of Saudi Arabia as an underdog*. Russia apparently does not believe that Saudi Arabia has enough resilience and room to maneuver to outbid Russia in this confrontation. Moreover, it seems that Moscow is deeply offended by the conditions the Saudis proposed which, had they been implemented, would have created the impression that Russia was Riyadh's junior partner in the OPEC+ configuration. This prospect appears to be totally unacceptable in the Kremlin. Many of Russia's leading analysts believe that inviting Russia to co-operate with OPEC was more vital for this organization itself – not for Russia (Rossiya 24 2020). Russia may also be aware of the fact that despite seeming economic omnipotence, Saudi Arabia is far more dependent on oil revenues than Russia is (ITON.TV-2 2020). On the other hand, Saudi Arabia – as an informal leader of OPEC – has far greater responsibilities to its members (including the need to balance the oil market) than Russia, which means that Moscow has room to maneuver, while Riyadh's freedom of action is constrained by its position within the organization and related obligations to its members. At the same time, as Ellen Wald (2020) argues, "about one-fifth of all [Saudi] citizens bought shares [in the initial public offering of Saudi Aramco]" whose price is rapidly plummeting, and if Riyadh fails to stabilize oil prices, "it will have a very disgruntled 20% of its population."

It would be fair to state that Russia premised its hardline behaviour on a combination of three key factors. First, Russia believes that the current collapse of oil prices is cyclical and temporary, and some sort of stabilization is bound to arrive. Second, Russia thinks the resources in its Stabilization Fund will allow it to weather adverse economic conditions. Third, Russia is confident that its negotiation position is superior to that of Saudi Arabia, meaning that a compromise will be reached anyway.

RUSSIA'S BARGAINING POSITION: SWOT ANALYSIS (A RETROSPECTIVE VIEW).

A SWOT analysis, measuring the internal and external factors that determine Russia's position, will help us understand whether this logic is justified.

(1) Strengths

First, the "psychology of the winner". Beginning with the 2003 U.S.-led intervention in Iraq, Russia has been gaining one geopolitical victory after another in confrontations with Western players. It was hard to imagine that the Kremlin would have openly bowed to the Saudis' proposed conditions. Ordinary Russians would not have understood such a move, and it would also likely have been ridiculed abroad. Russian rulers, impervious to international pressure, were unlikely to take a unilateral step backward, given their past behaviour. For example, in 2014, many observers thought Western sanctions would force them to assume a softer stance, but that never happened.

Second, Russia is resilient in times of shocks or crises. Unlike the Saudis, Russians are much more used to meagre living standards. Both older Russians (who remember the dire economic conditions of the 1980s and 1990s) and younger ones (affected by the consequences of the post-2014 economic sanctions) can adjust to aggravating economic conditions.

Along with propaganda and besieged-fortress narratives, Russian media spread stories about the 1986 U.S.-Saudi agreement, hinting that the same alliance is trying to hurt Russia's economy now. This reflects attempts to get the Russian population to blame outside parties and not Moscow for the drop in living standards. Similarly, the Russian economy – which has survived a number of crises since 1998 – is seemingly better prepared for the current havoc in the global oil market.

The third factor is the floating exchange rate. Neither the government nor the Central Bank determines the ruble's exchange rate. This gives Russia a certain advantage over other countries whose GDPs also rely heavily on the export of raw materials, since it "helps Russia to adjust to changing external conditions, smoothing out the impact of external factors on the economy" (Bank of Russia). Western sources have claimed that if oil prices do not rebound to an acceptable level, Saudi Arabia will be able to use its foreign currency resources for four years without major consequences (Andrianova and Omar 2020). According to the Russian Ministry of Finance, if Russia were to face similar challenges, its reserves would be sufficient to prop up the economy and compensate for budgetary losses "for the next six to 10 years" (RIA Novosti 2020a). Such an assessment, however, seems overly optimistic, given Russia's military expenditures, dependence on oil/gas revenues and other factors.

(2) Weaknesses

First, there is the veneer of stability. Indeed, in comparison with other (primarily Western leaders) Putin enjoys a high level of popularity among Russians, although that may not last. Putin's recent manipulation of the Russian constitution, allowing him to be president for life, has already resulted in growing public discontent, especially among younger to middle-aged educated Russians (Rosbalt 2020a). If Putin fails to fulfil his promised package of ambitious social programs (RIA Novosti 2020b), his popularity ratings could plummet to the level where they were between 2011 and 2013. If this happens, firing the government will not be an option, since Putin will be directly blamed for the lack of economic growth. Indeed, Alexei Kudrin, chair of the Accounts Chamber, thinks it possible that the Russian economy will stagnate. Russian economic analyst Vladislav Zhukovsky has expressed a similar idea, arguing that the overly optimistic scenario the Ministry of Finance has painted for 2020 is absolutely unrealistic, "instead of one to two per cent growth … The time has come to say that this year the Russian economy will be stagnating." This will result in a further decline in living standards, with small and medium-sized enterprises significantly affected. More importantly, he argued that Russia will have to forget about funding and developing expensive new oil and gas projects (Ballin 2020).

Second is Russia's general inability to increase oil production. Unlike Saudi Arabia and some OPEC countries, Russia's ability to significantly increase oil production seems unfeasible. According to Igor Yushkkov, the leading analyst at the National Energy Security Fund (NESF), Rosneft and Gazprom Neft do not have opportunities to significantly increase production; this is further aggravated by the fact that many Russian oil fields have already demonstrated decreased output, meaning that "our main task is to at least hold on to the current level of output" (EurAsia Daily 2020). The most optimistic calculations suggest that Russia might be able to increase oil production by two to three per cent, but it is unknown how long it will be able to maintain this pace in the longer term.

(3) Opportunities

The majority of Russian economists and financial consultants find it difficult to see any opportunities in the current economic circumstances. Current optimistic scenarios use the post-2014 period of economic sanctions as a template for forecasting future scenarios. At this juncture, there are three main opportunities (Nikitina and Bakhtina 2020). First, the ruble's decreasing value and its volatility should have proven advantageous to Russian producers. While this might have been feasible under different circumstances, this option is unlikely to work now, since oil prices are plummeting faster than the ruble, resulting in less benefit for domestic producers. Second, Russia might try to press even further in the realm of import substitution policy (launched in 2014), yet this opportunity seems to be bleak as well. While results of this policy are questionable (prices for domestically produced commodities are still very high and Russia still relies on imports now coming from the EU, China and non-EU countries), the continued fall of real wages in Russia will minimize the potential positive side of this policy. Third, conservative Russian economists suggest that the current situation could give Russia a chance to increase its non-raw materials and high technology products. However, given the current economic sanctions, an abundance (and technological strength) of competitors and limited markets for these types of Russian products, the room to maneuver seems limited.

(4) Threats

Perhaps the most serious threat was the fact that Russia's hardline approach effectively challenged not merely Saudi Arabia (which would be very tough competition on its own), but also other OPEC nations and the U.S. Following the breakdown of negotiations, Nigeria decided to increase oil production to two million barrels per day (Rambler 2020). At the same time, Saudi Arabia and Kuwait agreed to start oil extraction in the Saudi-Kuwaiti neutral zone (Khafji and Wafra fields), which has a potential of 500,000 barrels per day (Finanz.ru 2020a). On top of that, Iraq and the United Arab Emirates have sided with Riyadh (DiPaola, Cho and Cang 2020). As Ole Hansen, head of commodity strategy at Saxo Bank says, "Saudi Arabia and its Persian Gulf friends have very deep pockets. They can, arguably, maintain oil prices below $40 per barrel for months, especially if they are able to decrease their expenditures" (Finanz.ru 2020b.).

Russia faces a second major threat with the global outbreak of COVID-19 and its potential impact on the Russian economy. Russia has not yet been severely affected, but this could change. According to a survey conducted by the Chamber of Commerce and Industry of the Russian Federation (CCI), if matters grow worse, approximately 8.6 million Russians could lose their jobs (Degotkova 2020). Despite flamboyant rhetoric emanating from Russia's financial ministry about enough reserves to weather economic hardships, the CCI's scenario is next to apocalyptic. If the consequences of the virus are as harsh as predicted (and oil prices do not rebound), Russian reserves will melt at a breathtaking speed and foreign investors' confidence in the Russian economy (already shaken by the economic sanctions) will greatly suffer.

It is important to note that amid the price war with Saudi Arabia, leading Russian diplomats and experts on the Middle East and North Africa advised Russian elites to drop their hard-line stance on the issue. One such prominent expert, Andrey Baklanov (2020), said Russia was not prepared to "wage this war" against a group of very powerful players "especially under the current economic circumstances", meaning that "returning to OPEC+" or even entering into an OPEC++ agreement would the best solution for Russia.

CONCLUSION: A NEW OPEC+ DEAL: "TREATY OF BREST-LITOVSK"[1] FOR RUSSIA AND IMPLICATIONS FOR CANADA

Finally, on April 12, OPEC+ countries signed a deal agreeing to cut oil output by a record 9.7 million barrels per day. While Putin's spokesman, Dmitry Peskov, described the deal as an "unconditional success of the efforts of OPEC+ ministers" (Tass 2020b), and stated that Russia does not lose out in this agreement, other Russian experts have been less optimistic. Before the deal was signed, Fedun compared it to the Treaty of Brest-Litovsk – "because it is similarly humiliating and hard" for the Russian oil industry (Rosbalt 2020b). Mikhail Krutikhin, a partner at Moscow-based RusEnergy, called the deal "humiliating" and forecast long-term adverse consequences for the Russian economy. He also noted that cutting oil production will be far more difficult and expensive for Russia than for Saudi Arabia, owing to both climatic and technological differences in oil extraction (Krutikhin 2020). Other Russian economists and oil experts admit that the deal was not a matter of choice but inevitability: if not concluded now, the price war would have had detrimental consequences for the Russian oil industry, and arguably, the whole Russian economy (RBC 2020a). While the deal is presented in Russia as an undisputed political success (the same rhetoric emanates from Washington and Riyadh), oil prices continue to fall (Rosbalt 2020c). Given current trends and the uncertainty over COVID-19, it could take more than two years to stabilize global oil prices, possibly resulting in yet another disagreement (even a price war) among oil-producing countries. Specifically, if oil prices remain at a level of $30 per barrel, this might trigger further disagreements between the U.S. (a shale oil producer) and Russia (potentially siding with Saudi Arabia). At the same time, Russia's expensive oil and gas-related projects (in the high north and the Caspian region) could be shelved due to a lack of investments. Shell has already decided to walk away from a joint project (Yamalo-Nenets Autonomous Okrug) with Gazprom Neft "under the influence of external negative factors" (Gazprom 2020). The current oil crisis will inevitably make Russia even more dependent on China.

An analysis of Chinese sources suggests that during the Saudi-Russian dispute, the Chinese were trying to capitalize on the situation by enacting policies that would please Moscow. One article states that "China is a key to the solution of Russia's energy dilemmas … This means that she [Russia] could assume dominance on the global energy market by intensifying co-operation with China", which "by 2040 will become the largest oil consumer in the world" and still is the largest consumer of Russia's rich natural resources. The article concludes that "[U]nder the circumstances of growing volatility on the global energy market, Russia needs Chinese support more than ever" (Tintin 2020). This scenario could be particularly dangerous for Canada for two reasons. First, in light of the Huawei affair (BBC 2018), and the subsequent arrests of two Canadian citizens in China, relations between Ottawa and Beijing have experienced a serious rupture. Second, China has ambitious plans around its interests in the Arctic – an area of strategic interest for Canada – as a means to get access to local natural resources. Russia, which is superior to Canada in terms of icebreakers and other equipment (Sukhankin 2019a), is accommodating Chinese interests (Sukhankin 2019b).

1 The Treaty of Brest-Litovsk (March 3, 1918) was a peace treaty between the Bolshevik government of Russia and the Central Powers, which orchestrated Russia's withdrawal from the First World War, and was marked by huge territorial losses for Soviet Russia.

For Canada, oil price destabilization presents a serious challenge. The Canadian oil industry has been hit very hard since the initial breakdown of negotiations in Vienna. In addition to having “some of the cheapest barrels on the planet” (Morgan 2020), Canadian oil producers have been affected by the dramatic drop in demand caused by COVID-19. As Richard Masson and Jennifer Winter (2020) argue: “Canada had already suffered a massive decline in capital spending by the petroleum sector” and a conflict between the Saudis and Russians (aggravated by the outbreak of COVID-19) could present difficult new challenges for the country and some of its provinces that are particularly dependent on oil revenues, such as Alberta. They also note that the oil deal did not eliminate the main source of disagreement, and Alberta’s economy will take yet another severe hit. While oil prices are unlikely to rebound in the next couple of months, local oil producers will end up “having to pay people to take their oil because they don’t have a place to put it” (Bell 2020).

Given global trends in the oil industry (the oil deal is unlikely to bring about long-term sustainability), mounting uncertainties over demand for oil as well as doubts about commitment by other players to decrease their oil output (including Russia, Nigeria and Kazakhstan), the next several months will be extremely difficult for the Canadian oil industry.

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